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Minutes of Executive Board Meeting 86/82

10:00 a.m., May 16, 1986

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	J. K. Orleans-Lindsay, Temporary
	D. C. Templeman, Temporary
	E. L. Walker, Temporary
	K. Celebican, Temporary
M. Finaish	
	M. Sugita, Temporary
	A. Bertuch-Samuels, Temporary
Huang F.	
	Jaafar A.
A. Kafka	H. A. Arias
	R. Fox, Temporary
	I. Puro, Temporary
	L. Leonard
	W. N. Engert, Temporary
	J. A. K. Munthali, Temporary
F. L. Nebbia	
	S. Geadah, Temporary
P. Pérez	J. de la Herrán, Temporary
	G. Nguyen, Temporary
	J. de Beaufort Wijnholds
	A. V. Romuáldez
G. Salehkhou	
	A. S. Jayawardena
	A. Vasudevan, Temporary
	N. Kyriazidis

L. Van Houtven, Secretary
J. W. Lang, Jr., Acting Secretary
B. J. Owen, Assistant

Also Present

IBRD: N. Ramachandran, Latin America and the Caribbean Regional Office; S. Yusuf, East Asia and Pacific Country Programs Department. Asian Department: H. Neiss, Deputy Director; J. R. Marquez-Ruarte, S. Shah, X. Vongsathorn, K. Yoshinari. Central Banking Department: C.-J. Lindgren. Exchange and Relations Department: W. A. Beveridge, Deputy Director; M. Guitián, Deputy Director; E. H. Brau, S. Kanesa-Thasan. Legal Department: P. L. Francotte, J. K. Oh, J. V. Surr. Western Hemisphere Department: S. T. Beza, Associate Director; J.-P. Amselle, A. Caetano Filho, M. Caiola, M. A. Da Costa, R. A. Elson, H. Ghesquiere, T. Gudac, P. Habananda, H. E. Khor, T. F. Lehwing, C. G. Muniz B., G. C. Pastor, T. M. Reichmann, I. C. Tandeciarz, B. M. Traa, S. Umana, F. van Beek. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: S. Ganjarerndee, G. D. Hodgson, H.-S. Lee, P. Péterfalvy, M. Z. M. Qureshi, Song G., M. A. Weitz. Assistants to Executive Directors: J. R. N. Almeida, O. S-M. Bethel, J. J. Dreizzen, V. Govindarajan, A. H. Mustafa, J. Reddy, J. E. Rodríguez, V. Rousset, D. Saha, S. Simonsen, B. Tamami, H. van der Burg.

1. ST. CHRISTOPHER AND NEVIS - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with St. Christopher and Nevis (SM/86/83, 4/22/86). They also had before them a report on recent economic developments in St. Christopher and Nevis (SM/86/87, 4/29/86).

Mr. Leonard made the following statement:

The authorities in St. Christopher and Nevis are in broad agreement with the staff's analysis of economic developments in the islands and with the thrust of its conclusions.

The economic performance of St. Christopher and Nevis weakened in 1985. The rate of growth of GDP fell to slightly over 1 percent from about 3 1/2 percent in the previous year mainly as a result of a marked reduction in sugarcane output reflected in turn by lower sugar production in the manufacturing sector. Output of other manufactured goods also declined. The current balance on external account widened although the overall balance remained positive and approximately constant as a proportion of GDP. The rate of price rise eased to about 2 1/4 percent. Overall public sector savings moved from a positive 1.4 percent of GDP in 1984 to a negative 3.9 percent in 1985. In both years, savings of the consolidated Federal Government sector were negative, evidence of a deteriorating trend.

The performance of the economy is expected to improve in 1986 with a rise in the growth rate to about 5 percent. The upturn is primarily cyclical and the authorities accept that the future prosperity of the islands depends on structural action in the direction of diversifying the agricultural sector away from sugar and on expanding the tourism and manufacturing sectors. They are also in agreement with the staff that present fiscal weaknesses need to be made good and public savings increased.

Following the rise in the current budget deficit to 6 percent of GDP in 1985, a number of discretionary measures to raise revenue were enacted in the 1986 budget. Increases in water and port charges were also provided for, and in a far-reaching effort to restore profitability to the sugar industry, it was decided to bring the cane-growing and sugar-manufacturing operations more closely together under a single authority and that the Federal Government should assume responsibility for the debt obligations of the industry to the National Bank. In addition, the position of the Social Security Scheme as a major source of saving was assisted by an increase in the contributions paid by employers. Together the measures outlined are expected to improve consolidated public sector revenues by some 2 percent of GDP and to eliminate losses by the public enterprises taken as a whole.

Unfortunately, the current budget deficit of the Federal Government will persist, largely as a result of a civil service pay increase awarded early in 1986 and rising interest payments. Overall, when capital revenues and expenditures are taken into account, a public sector deficit of nearly 12 percent of GDP is in prospect and has yet to be addressed, whether by fiscal or financing action. The authorities recognize the financial inappropriateness of the pay increase at the present time but believe that it was necessitated by the length of time since the last increase in 1981 and the fact that pay increases had taken place in other activities in the meantime. They also acknowledge that the size of the public sector pay bill has to be contained over the medium term and favor doing so by a reduction in the numbers employed and by reshaping the structure of administration. To that end, staff vacancies this year are being left unfilled.

Interest costs, although small in relation to GDP and total government revenue, are likely to remain a burden for some years to come and could become heavier as a result of action to remunerate the Social Security Scheme for the use of a part of its resources in paying off the sugar debt to the National Bank. The action to be taken has yet to be settled by the authorities. Over time, the problem of bridging the financing gap should be eased insofar as sugar production becomes profitable, the proceeds of sales of sugar lands are used to reduce borrowings, and government revenues benefit from the development of the southeast peninsula which is now being assisted under the Public Sector Investment Program.

As indicated earlier, the current external deficit widened somewhat (to nearly 13 percent of GDP) in 1985 but the overall balance was positive. With successful rehabilitation of the sugar industry, continued buoyancy of tourism and export-oriented private sector activities, and expected capital inflows, the evolution of the external account should remain satisfactory in the years ahead and could possibly improve, if sales of sugar lands are well managed. Despite a sizable increase in external debt--both absolutely and as a proportion of GDP over the remainder of the decade--the debt service ratio will remain in low single figures because of the concessionary terms of the loans.

The authorities do not see any pressing need for positive use of the exchange rate as a means of promoting external competitiveness. They consider that low absolute unit labor costs, the fall in the value of the U.S. dollar to which the EC dollar has a fixed link, and low real appreciation of the domestic currency relative to that of trading partners has adequately protected the ability of domestic producers of goods and services to compete in domestic and external markets.

As indicated in my statement to the Executive Board on the 1985 Article IV consultation last year, St. Christopher and Nevis is fortunate in the vitality and enterprise of its private sector. It is also favored by the possession of undeveloped tourist potential and considerable agricultural land capable of producing a wide variety of crops other than sugar. The public sector investment prepared by the Government in consultation with the World Bank and major donors aims at developing these resources by strengthening the economic infrastructure, promoting agricultural diversification, and supporting the role of the private sector. In turn, progress in these directions will provide more employment, better living standards, and improve the base of the public finances.

Mr. Fox said that the prospects for St. Christopher and Nevis were quite encouraging in many respects. In the short term, growth would receive a cyclical boost, and inflation remained very low. Manufactured exports had been growing quite rapidly, and the decline over the past year in the U.S. dollar, to which the East Caribbean dollar was linked, should have improved export prospects in non-dollar areas. The current account deficit had been more or less covered recently by direct investment, and what borrowing there had been was on concessional terms so that the debt service ratio remained very low. Certainly, unemployment was a major problem but the authorities' development strategy seemed the most sensible way of tackling it. The recent moves to reorganize the sugar industry were important and welcome, and the prospects of reducing dependence on sugar in the longer term appeared encouraging, given the potential for tourism to the islands.

However, it was clear from the staff report that the authorities had a major fiscal problem on their hands, Mr. Fox continued. Indeed, the consultation process seemed to have played an important part in drawing that problem to the authorities' attention, since their own budget projections, as described in the staff report, took an unduly optimistic view of the fiscal outlook. At the time of the consultation, the authorities had apparently agreed with the staff's more pessimistic projections but had not focused on how to reduce the budget deficit to a more sustainable level. Mr. Leonard had made it plain that they were still no further forward in their thinking, and that they might even be contemplating financing the deficit rather than reducing it. Further clarification in that respect would be helpful. For instance, he wondered whether the authorities still ruled out the measures, such as higher consumption taxes and utility rates, suggested by the staff during the consultation. It would also be useful if the staff could elaborate on the consequences of trying to finance an overall federal government deficit of 12 percent of GDP, including the effects on domestic credit and the balance of payments.

Given the relatively low tax burden in St. Christopher and Nevis, compared both to other islands and to the situation in St. Christopher and Nevis in the early 1980s, there was clearly scope for increasing tax revenues, Mr. Fox remarked. However, the authorities' expectation of higher property tax receipts following the reassessment of land values seemed likely to depend on prior improvements in the system for collecting that particular tax.

On the expenditure side of the budget, both current and capital spending were expected to remain at or even to exceed the already high levels reached in 1985, suggesting that there was room for economizing on both accounts, Mr. Fox continued. On the capital side, the authorities should at least stick to the revised public sector investment program; even better, they should cut back on some of the projects that relied for their financing mainly on domestic savings, pending a better savings performance in the public sector. A large increase in current expenditures was inevitable, following the substantial pay award to civil servants in January, making the need for economies in other areas all the more important. While that pay rise was the first since 1981, it had also been almost double the increase necessary to make up for inflation since that time. Moreover, it would have unfortunate effects on wages outside the public sector. He asked whether the authorities saw any advantage in setting public sector wages more frequently in the future; the effects on the overall wage structure might be less disruptive. The increase in wage costs, on top of the depreciation of the exchange rate over the past year, raised the possibility of a higher rate of inflation than the 2.5 percent projected for 1986. Admittedly, the rate of imported inflation would be determined largely by the rate of inflation in the United States, since more than half of the imports of St. Christopher and Nevis came from the dollar area, and the fall in the price of oil would be a further moderating influence.

Mr. Romuâldez considered that there were many reasons for optimism about the prospects of St. Christopher and Nevis. For 1986 in particular, a significant upturn in economic growth seemed likely, led mainly by tourism and construction. The rate of inflation should remain moderate; the terms of trade would probably show a slight improvement; and the overall balance of payments position was likely to be maintained as capital inflows were expected to continue to more than cover the current account deficit. In addition, the authorities were relatively optimistic about the outlook for exports in the five years ahead.

The general thrust of the development policies being pursued by the authorities was also encouraging, Mr. Romuâldez said. Those policies were designed to reduce the traditional dependence of exports and employment upon sugar production. In that respect, it was gratifying to note that the World Bank was in general agreement with the authorities' two-pronged development strategy aimed at reorganizing the sugar industry and diversifying the economy.

However, a significant cloud on the horizon was the possibility that the serious deterioration of the fiscal position that had occurred in 1985 would continue, unless significant measures were taken to eliminate the fiscal gap, Mr. Romuáldez continued. In 1985, the overall public sector deficit had reached 11 percent of GDP, and the staff estimated that, in the absence of any corrective measures, the deficit in 1986 might be almost 12 percent of GDP. In financial terms, the unfinanced fiscal gap that might emerge in 1986, which the staff had estimated could approach 10.5 percent of GDP, was clearly unsustainable, for several reasons. First, the National Bank was in a difficult financial position, its liquidity having been seriously impaired by the heavy public sector borrowing in 1985; second, the situation of the social security scheme had weakened; and third, it was inadvisable for the authorities to seek nonconcessionary external financing. Even assuming that the authorities adopted measures to eliminate the fiscal gap, the staff estimated that outstanding external debt would increase significantly in relation to GDP in the coming years from nearly 30 percent at the end of 1985 to about 38 percent at the end of 1990.

Equally important, the effects of the continuation of a deficit of that size could be significant in real terms, Mr. Romuáldez added. The expansion of the export-oriented and tourist industries, which would be vital to the nation's future development, could be jeopardized by failure to strengthen the public finances promptly, thereby increasing the level of domestic savings needed to effect necessary structural changes.

The staff had outlined clearly the measures required on both the revenue and expenditure sides of the public sector budget, Mr. Romuáldez observed. He fully endorsed the staff appraisal that "the effort needed to repair the public finances is very large and requires measures on many fronts." He urged the authorities to consider seriously the proposals made by the staff. Their attitude to those proposals was not apparent from the staff report: in some places, the authorities seemed not to be prepared to acknowledge fully the likely dimensions of the fiscal problem, on the basis of the maintenance of current policies, even though the staff regarded the budget estimates for 1986 to be on the optimistic side for revenue and on the conservative side for expenditure; in other places in the staff report, the authorities appeared to be aware of the magnitude of the problem but unwilling to contemplate additional measures at the present time. For instance, the staff had reported that at the time of the consultation, the authorities had agreed in general on the magnitude of the unfinanced fiscal gap. A clearer indication of the authorities' approach to the fiscal problem identified by the staff would be helpful.

The World Bank had expressed concern about the state of public finances and the capacity of the Government of St. Christopher and Nevis to generate the domestic savings required to support the investment program, Mr. Romuáldez noted. He understood that the Bank had recommended a restructuring of the public sector, and he would welcome an indication of the authorities' response to that recommendation.

In conclusion, Mr. Romuáldez said that he had no difficulty supporting the staff appraisal; he urged the authorities to act quickly and decisively to respond to the fiscal challenge identified by the staff.

Mr. Arias noted that the staff had appraised recent economic developments in St. Christopher and Nevis in a well balanced report, with which he was in general agreement. Like other small island economies in the Caribbean, St. Christopher and Nevis suffered from certain structural weaknesses, among them an insufficiently developed structure of production and exports. The consultation and the accompanying review of recent economic developments had provided ample evidence of the continuing high degree of vulnerability of the economy to adverse external circumstances and of the resulting constraints on the country's capacity to achieve long-term growth and the structural transformation of the economy. For that reason, his chair welcomed the authorities' objectives of diversifying the economy by fostering the development of tourism, the output and export of manufactures, and domestic agricultural production. He had found Mr. Leonard's statement to be most instructive in that connection.

Notwithstanding those general problems of economic management, St. Christopher and Nevis had made considerable progress toward the establishment of conditions for sustained economic growth, especially considering that the authorities were undertaking appropriate adjustment in face of a serious and deteriorating situation in the sugar sector, Mr. Arias continued. As shown in the staff report, sugar production and exports had experienced significant declines in terms of both volume and prices. Accordingly, the terms of trade of St. Christopher and Nevis had fallen by 2.6 percent but real GDP growth had remained positive, and the rate of inflation had been maintained at approximately 2 percent during the past four years, wage restraint having been an important element in the overall economic strategy.

Despite those reasonably satisfactory developments, certain worrying features persisted, Mr. Arias remarked. The unemployment rate was estimated to be 20-25 percent; the public finances continued to deteriorate, with the consolidated overall deficit estimated at 11.2 percent of GDP in 1985; and the current account of the balance of payments remained in deficit to the extent of 10.1 percent of GDP in 1985. The magnitude of the adjustment required to correct those internal and external imbalances imposed a heavy responsibility on the authorities. To ensure that an appropriate balance was struck between adjustment and growth, adequate amounts of external bilateral and multilateral concessional resources were indispensable, as was the need to improve the mobilization of domestic financial resources.

Given the high unemployment, the authorities understandably wanted to limit the contractionary effects on growth of a drastic reduction in domestic absorption, Mr. Arias observed. Therefore, their decision to implement a five-year rolling development plan was a step in the right direction in the current structural environment. Appropriate priority had been accorded in the development plan to the implementation of a three-year public sector investment program, covering the period 1986-88, a program that had been drawn up in collaboration with the Inter-Agency Resident Mission (IARM). The staff might wish to comment in that light on the long-term growth rate based on current projections of investment, and on whether the rate of growth of 5.2 percent that it had projected for 1986 and current investment trends were sufficient to reduce the existing high and socially unacceptable level of unemployment.

The authorities' recent decision to strengthen public finances--a major source of the country's current difficulties--was welcome, Mr. Arias stated. He urged them to take prompt action aimed at improving resource allocation in the public enterprise sector, an essential part of any strategy to generate adequate public sector savings in the years ahead.

Mrs. Walker remarked that economic developments during 1985 in St. Christopher and Nevis had pointed once again to the vulnerabilities of small island economies. Exogenous events affecting the sugar industry had led to a slowdown in growth of total output to 1 percent for the year. Furthermore, the finances of the Consolidated Federal Government had deteriorated sharply and overall public sector savings had become negative. The trade account had continued to register a large deficit, although the current account deficit had narrowed and the overall balance of payments remained positive.

While she had noted the expected improvement in the rate of economic growth during 1986, she agreed with Mr. Leonard that the upturn would be mostly cyclical, Mrs. Walker added. Therefore, she welcomed the authorities' acknowledgment that the future prosperity of the islands depended on diversifying the agricultural sector and expanding other sectors, as well as on an improvement of the fiscal position of the Consolidated Federal Government and the savings ratio. The projection of the fiscal deficit for 1986 was alarming, particularly since the authorities had yet to decide on action to bridge the projected financing gap of 10.5 percent of GDP for the year. The staff had outlined some measures for consideration by the authorities in order to close that gap but they appeared to have declined to consider most of them. The lack of resolve in the fiscal area was of concern; action along the lines proposed by the staff needed to be taken immediately. While the authorities had announced measures that would increase current revenue by about 2 percentage points of GDP, additional revenue was needed; it could be gained by a further increase in utility charges, particularly for water, and perhaps by increasing property taxes and import duties. There might be other opportunities for reducing expenditure on outlays for investment financed by domestic resources. The recent wage increases--of 22.5 percent on average--were most unfortunate, particularly as inflation had been so low and wages appeared to be competitive, making the country attractive to foreign investment, and at a time moreover of such a weak fiscal situation.

The practice of using the deposits held by the Social Security Scheme to service the sugar debt to the National Bank might provide short-run liquidity but it could mean trouble in the long run, Mrs. Walker considered. Basically, the problem was being shifted from one part of the public sector to another. The Social Security Scheme was not only losing investment income but it would eventually have to begin making payments, from a possibly weak financial position.

Immediate action should be taken by the authorities to reduce the public sector deficit, Mrs. Walker stated. It was inconceivable that such a large financing gap could be sustained in 1986 if any scope was to be retained for improving the fiscal position in 1987 and beyond. A strengthening of the public sector finances would also increase the country's domestic savings, savings that would be needed to finance structural changes in the economy. Expansion of the tourist sector and other export industries would be critical to future economic growth. In that respect, she welcomed the attention being paid by the Government to attracting foreign investment into the manufacturing sector and the incentives being provided to the private sector for the construction of factory shells.

She had found Appendix A to the report on recent economic developments to be quite interesting and helpful in understanding the problems of the sugar industry in St. Christopher and Nevis, Mrs. Walker commented. That industry obviously dominated the economy but was in need of reform to reduce inefficiencies and increase productivity. While the plans of the Government to rehabilitate the sugar sector were expected to result in the industry's return to financial viability in 1987-88, the prospects for diversification of the economy rested in part on the ability to economize on the resources devoted to the sugar sector. If some of the land used to grow sugar cane was to be devoted to other purposes, the productivity of the remaining sugar lands would have to increase and extra efforts would be required to ensure that result.

Finally, Mrs. Walker noted that like many other small island economies, St. Christopher and Nevis was affected by exogenous developments and heavy reliance on one industry. The authorities must take urgent action on the fiscal front and implement with determination their plans to improve the sugar industry and diversify the economy; there was little time for delay.

The staff representative from the Western Hemisphere Department said that although average rates of unemployment in St. Christopher and Nevis were high, a large cyclical factor was at work owing to the nature of sugar cane cultivation. One of the reasons for modernizing and increasing the productivity of the sugar industry, including in particular the importation of mechanical harvesters, was to help deal with the labor shortage during the peak harvest period. The Government's strategy of diversification was also aimed at using the pool of unemployed labor during the rest of the year by promoting the cultivation of other crops, including winter vegetables, that would be harvested in the off season for sugar, thereby ensuring a more even distribution of employment opportunities throughout the year. The direct impact of the public sector investment program on labor absorption was not likely to be great, as experience in other countries with a similar economic makeup had shown. Investments in roads and other infrastructure were often highly capital intensive. The demand for labor was more likely to increase when such investments came to fruition, particularly in the manufacturing sector; once factory shells were built and export-oriented industries began to operate, considerably more labor was absorbed. The same could be said about the tourism sector, which expanded and employed more people only after the completion of construction projects, including roads.

During the consultation discussions, the authorities had been greatly concerned about the Consolidated Federal Government's financing gap, the staff representative said. However, they had not been prepared at that time--and according to Mr. Leonard's statement, they remained unprepared--to indicate what effective action could be taken on the revenue or expenditure side to narrow that gap. While there appeared to be room to increase revenue, the tax burden being considerably lower in St. Christopher and Nevis than it was in most other similar countries in the region, the staff had the impression that the authorities were leaning more toward a financial solution than toward fiscal adjustment. The overall unfinanced gap of the Consolidated Federal Government was in the neighborhood of EC$21 million, equivalent to 10.5 percent of GDP. If the surplus being generated by the Social Security Scheme were used as a source of financing, that gap would be reduced to about EC$13 million. However, the use of that surplus was not recommended because the Social Security Scheme would lose the income from the interest it earned on deposits held at the National Bank; its financial situation would also be adversely affected since any additional surplus generated by the excess of contributions to the Scheme over its expenditures could be tapped to finance the deficit of the Consolidated Federal Government. The method of financing the deficit reflected in Table 2 of SM/86/83 assumed that the buildup of deposits of the Social Security Scheme with the National Bank would not be used as a source of financing. The Federal Government could also finance part of its deficit by obtaining additional credit from the National Bank, a solution that would be equally inadvisable. It should be noted that the measures taken to increase revenue by 2 percent--mainly through an increase in the special levy on wages and contributions by employers--had been embodied in the projections of the financing gap of 2.5 percent of GDP.

The rate of inflation was unlikely to increase much as a result of additional investments, the staff representative from the Western Hemisphere Department explained. In open economies like that of St. Christopher and Nevis, an increase in aggregate demand usually had an impact on imports and employment rather than on prices. Pay increases granted by the Federal Government to civil servants had had a certain spillover effect on costs in the private sector and in the economy in general in the past. However, the most recent public sector pay increase was the first since 1981, whereas private sector wages had continued to increase over the past five years. Private sector wages thus might already have been adjusted and costs were unlikely to increase in percentage terms by as much as the latest increase in public sector wages would suggest.

Mr. Leonard observed that the problems of the sugar industry had already called for attention at the time of the 1985 Article IV consultation, when there had been signs of fiscal problems as well, including those resulting from the use of the deposits of the Social Security Scheme. However, among the positive developments of the past year, it was worth noting that the difficulties of the sugar sector had been tackled head on and that the production and processing of sugar cane would be put on a break even and possibly on a profitable basis.

As he had indicated in his opening statement, the authorities were fully seized of the need to find specific measures to deal with the fiscal deficit and to avoid drawing on the resources of the Social Security Scheme, but they had not yet decided what action to take, Mr. Leonard continued. As Directors had noted, the good management of the economy in the future was at stake; use of the funds of the Social Security Scheme would create a liability that could place a claim on future revenues of the Federal Government at a time of possible financial stringency.

The prospects for economic development in St. Christopher and Nevis were by no means unpromising, Mr. Leonard remarked. There was no doubt that the island's potential for development, which would benefit both individuals and the Government if it could be realized, might have led the authorities to put more emphasis on realizing that potential than on tackling the more immediate problems that were of concern to Executive Directors. The two most valuable assets of the country were the sugarlands and the southeast peninsula of the country. The latter offered substantial scope for tourism which was already being exploited. Unfortunately, use of the sugarlands for cane production was likely to yield diminishing returns over time. The authorities recognized that but were also aware that if those lands were well managed for other purposes, they would remain a significant natural resource. It must however be borne in mind that the country was newly independent, that there was a great desire to develop its economy as rapidly as possible, but that economic management was the responsibility of only a handful of officials who had to devote their efforts to a great variety of tasks. It was, therefore, to be expected that at the present stage some shortcomings in performance were inevitable.

The surveillance of the Fund in the context of the consultation process, and the Board's advice, which he would convey to the authorities, no doubt would be helpful in highlighting the need for a proper balance between adjustment and growth if plans for the future development of the country were not to be frustrated by the need to constrain demand at a later date, Mr. Leonard concluded.

The Acting Chairman made the following summing up:

> Directors generally agreed with the thrust of the appraisal in the staff report for the 1986 Article IV consultation with St. Christopher and Nevis. For the immediate future, the economic outlook was relatively favorable, with activity expected

to be led by tourism and construction, and in an environment with a low rate of inflation. In addition, export prospects were encouraging and the debt service ratio was relatively low. However, Directors cautioned that much of the improvement in the economy was cyclical in character and expressed concern about the large fiscal deficit which had emerged in 1985. The continued vulnerability of the economy to external developments was also recognized.

Thus, Directors supported the Government's development strategy to reduce dependence on sugar and also seek to reduce the high level of unemployment by expanding tourism and export-oriented manufacturing. However, they observed that the implementation of the strategy called for a significant increase in public sector investments in the next few years and noted that this could only be achieved after a considerable strengthening of the public sector finances. They also pointed to the need for continued and indeed increased concessional foreign assistance.

Directors broadly agreed on the need to restructure the sugar industry. However, they drew attention to the danger of using the financial reserves of the Social Security Scheme to liquidate the sugar industry's debt since the actuarial integrity of the Scheme would be threatened by such a practice. With respect to the diversification of the economy, they also welcomed the authorities' policy of encouraging foreign investment.

Directors expressed particular concern about the size of the unfinanced gap in the budget projected for 1986, which at 12 percent of GDP was regarded as unsustainable, and stressed that prompt action was required to increase government revenues and also curb expenditures. In that regard, Directors urged that the authorities carefully consider the suggestions that have been put forward by the staff to raise both tax and nontax revenues. That was all the more urgent in view of the weak financial position of the National Bank, which has been the main source of financing for the Government.

Directors were concerned that the recent pay increase awarded to civil servants had not only aggravated the fiscal imbalance but also was likely to have an adverse effect on costs throughout the economy. Thus, Directors stressed the importance of a restrained wage policy to ensure the competitive position of the economy.

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

2. SURINAME - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with Suriname (SM/86/76, 4/11/86). They also had before them a report on recent economic developments in Suriname (SM/86/91, 4/30/86).

Mr. Kafka made the following statement:

My authorities wish to thank the staff for the well balanced technical appraisal of current and prospective developments in the Suriname economy, and they wish also to record their broad agreement with the contents of the analysis in the report. The appraisal in their view defines in clear terms the devastating cost of adjustment under the impact of adverse external shocks in terms of loss of output, declining per capita incomes, and, by extension, living standards, for a small, open, primary-producing developing country.

After a number of years of solid growth rates, Suriname has been experiencing a protracted economic contraction over the last four years--1982-85--with a cumulative loss of output and per capita income approximating 15 percent and 26.1 percent, respectively. These developments have been accentuated by the prolonged weakness in the market for bauxite and its derivatives and the virtual cessation of aid disbursements consequent on the political disturbances of 1982. The general contraction of the economy has been associated with substantial fiscal and external payments imbalances; the public sector finances, which through 1981 had been largely in equilibrium, shifted to a deficit position, and in 1985 comprised approximately 20 percent of GDP; in a similar vein, the external position has worsened as a consequence of falling prices for bauxite and its derivatives--the deficit being the equivalent of 17 percent of GDP in 1983, since when it has receded to 5.8 percent of GDP at the end of 1985. Consequently, when this factor is added to the effects of the interruption of the large inflows of public capital, net international reserves, which reached comfortable and adequate levels in the 1970s, became negative; external arrears, mainly suppliers' credits, began to accumulate and a parallel economy emerged. The expansion of domestic liquidity resulting from increased recourse to central bank financing led to sustained price pressures despite the introduction and subsequent tightening of generalized price controls.

In the implementation of economic policy, my Surinamese authorities hold the view that while an appropriate economic policy environment is an essential condition for the re-establishment of sustained economic growth, they are convinced that the severe deficiencies in the external environment--adverse terms of trade effects and cessation of aid--and the magnitude of the required adjustment are imposing an extraordinarily heavy burden on the Surinamese people. For this reason, they view a supportive international economic and financial environment as a critical element in the pursuit of economic adjustment. To this end, they are opting for a particular approach to adjustment encompassing a variety of measures in several areas which would have a gradual impact on the economy. The immediate implementation of a comprehensive adjustment program in the current circumstances would, in their view, be an ambitious objective since such an approach could only serve to undermine the fragile socioeconomic stability that now exists. Accordingly, my authorities are in the process of building a social and political consensus among the major groups in the country in support of an adjustment program, the formulation of which is under urgent consideration. In this scenario, the authorities envisage the gradual reduction of the fiscal imbalances over a period of four to five years.

The Surinamese authorities recognize that their economic problems stem mainly from a combination of scarce foreign exchange resources and the excessive dependence of the economy on the bauxite sector. The Government has, therefore, formulated a medium-term strategy, the main elements of which have been included in the National Reconstruction Plan (NRP) submitted recently to the National Assembly. This strategy aims at adjusting economic management to the new circumstances of an extreme foreign exchange constraint, and in the process placing increased emphasis on raising efficiency and production in the industrial--including energy--and agricultural sectors; the primary aim in this respect is to promote economic diversification and export promotion. The Government considers that socially required levels of investment and employment cannot be sustained in the context of a steady decline of the bauxite processing sector and in the absence of the large disbursements of external concessionary assistance. Accordingly, the present resource constraints, both external and internal, are having an adverse impact on development expenditures, which in 1985 were equivalent to 3 1/2 percent of GDP and were running at approximately 70 percent below 1982 levels. In these circumstances, the Government attaches the maximum importance in the Plan to the improvement in long-run capacity output and have accordingly identified key resource-based projects in the export sector--rice, palm oil, processed wood, ceramics, glass, soap, and bricks. The authorities consider that with reasonable investment the bauxite industry can continue to be a net provider of foreign exchange to the national economy over the medium to long term. In the interim, the Government is committed to adapting and improving the policy environment in a number of areas: key enterprises have been allowed to retain part of their foreign exchange earnings, and greater flexibility is being introduced in the foreign exchange budgeting system through greater "no funds" imports. These reforms are being implemented with a view to ensuring the maintenance of capital stock so that capacity utilization and cost structures could be improved. The authorities consider that the implementation of this scaled-down investment program and the ultimate success of the reforms envisaged are crucially dependent on the mobilization of both domestic and foreign financial resources.

The fiscal budget for 1986, recently laid in the National Assembly, contemplates a reduction in the consolidated Government deficit to 18 percent of GDP from 20 percent in 1985, that is being viewed as part of the long-term adjustment program. Indeed, the Government is convinced that a long-term solution to the fiscal imbalances, and to the generation of adequate public sector surpluses, requires a broad range of revenue and expenditure measures; it therefore stands ready to strengthen further the public finances so as to achieve a substantial reduction in the fiscal deficit as soon as a consensus on the recommendations of the tax reform commission is structured. Generally, the proposals of the commission are geared toward the creation of an environment of financial stability and thus of expectations to facilitate long-term private sector initiative and strategic planning, to support investment growth, and in the process to reduce the scope of the parallel economy. On the expenditure side, the operating performance of the revenue-earning public enterprises is being strengthened and streamlined. In this connection, the Government is committed to an appropriate policy of payroll restraint and views the recent signs of moderation in wage demands by the unions as indicative of the unions' concern for the maintenance of socially acceptable employment levels. Furthermore, recent legislation providing for improved job security is expected to strengthen private sector resolve in resisting inappropriate wage demands. Accordingly, the Government is convinced that an appropriate framework to avoid an inflationary wage-price spiral is being structured, and it intends to support this framework with a monetary policy stance which would aim at reducing excess liquidity through open market operations. To this end, they are in the process of structuring a government bond market.

Developments in the external sector are reflecting the economic crisis at the domestic level where the primary character of the export structure has been subject to significant exogenous shocks with consequential adverse effects for Surinamese exports in terms of both price and volume. The current account deficit increased from the equivalent of 6.5 percent of GDP in 1980 to approximately 17 percent of GDP in dollar terms. Export earnings are currently 45 percent below those of 1980, and it was inevitable that imports would be compressed: by 1985 imports were about one quarter below what they had been in 1983, and the current account deficit narrowed to 5.8 percent of GDP in 1985.

The impact of this import compression on the economy has been disastrous, both in terms of output lost and declines in per capita incomes and living standards.

The Government is firmly committed to the aim of a balanced external account but recognizes that attaining this objective requires structural adjustment of a kind that will lay the basis for sustained noninflationary growth; in its view this process will depend critically on strengthening the main productive sectors as well as on the stimulation of exports in nontraditional sectors. Given the limited resources at its disposal, external financial support--in the view of the Government--is a critical factor if the primary goal of reconstructing the Surinamese economy toward the tradables sectors is to be achieved. It is only through this process and indeed only within a medium-term framework that internal and external equilibrium will be restored.

The stability between the U.S. dollar and the Surinamese guilder has been an important instrument of economic policy in Suriname. The authorities recognize that the effectiveness of the exchange rate instrument depends on the particular circumstances of individual countries, and that any action to induce a devaluation, as recommended by the staff, despite supportive policy action, could generate an inflationary wage price spiral and aggravate an already difficult economic situation. In the present circumstances, therefore, the authorities believe that an improvement in the competitive position of Suriname should be pursued through domestic cost restraint rather than through the use of the exchange rate. The adoption of a firm incomes policy represents a forceful effort to achieve this objective. Indeed, the authorities are convinced that the correction of pervasive rigidities in the economy of Suriname requires significant capital inflows to improve the long-term output capacity which would crucially determine the effectiveness of any exchange rate action.

The Surinamese authorities consider that given the present and prospective financial requirements, and the fact that external financial assistance has virtually ceased, it was inevitable that some external arrears would arise--a development they deeply regret. The authorities attach the highest priority, therefore, to the discharge of these short-term obligations and they have made provision for their liquidation in the foreign exchange budget for 1986. In any event, Suriname considers its external debt to be favorable and modest at 11 percent of GDP and 25 percent of merchandise exports and is of the view that external financing requirements over the medium term are not beyond the country's capacity and creditworthiness. They envisage a structural improvement in their balance of payments as the implementation of projects in the industrial, energy, and agricultural sectors are undertaken, and with an appropriate restraint on domestic demand, external debt can be kept within manageable limits despite an increase in external financing.

Mr. Wijnholds observed that the economic situation in Suriname had continued to deteriorate during 1985. For the fourth year in a row, real GNP had declined and was 25 percent below what it had been in per capita terms in 1981. The country's external reserves had been exhausted, and substantial external arrears had accumulated. At the same time, the fiscal deficit had reached some 20 percent of GNP, and as it had been financed mainly by recourse to bank borrowing, there had been a rapid increase of liquidity in the economy. The authorities had tried to cope with those problems by placing increasing reliance on price and exchange and trade controls. Although those measures had resulted in some decrease in imports, prices had risen by 15 percent, despite the price controls. Taking parallel markets into account, the actual rate of inflation was likely to have been considerably higher.

Suriname's problems, which were set out clearly in the staff report, stemmed from declining receipts from exports, mainly of bauxite and its derivatives; from the suspension of development aid from the Netherlands whose position on the resumption of aid had not changed; and from the Government's inadequate response to those developments, Mr. Wijnholds continued. The authorities were obviously still insufficiently aware of the need for adjustment and the country continued to live beyond its means. Increasingly heavy reliance was being placed on controls, which were administered in an ad hoc manner. He fully shared the staff's concern about the damaging degree of uncertainty that resulted. Ultimately, production would be driven out of official markets, thus putting further pressure on the government finances and leading to a rapid expansion of parallel markets. In turn, there might well be a further increase in social tensions. Moreover, any further compression of imports would severely harm the position of enterprises, undermining production and exports to an even greater extent. The need to put a comprehensive adjustment policy in place was thus indeed urgent. The key elements of such a policy should be the correction of the government finances, a reduction in unit labor costs, a realistic exchange rate, and the elimination of controls or, at the very minimum, making those controls more transparent.

The correction of the imbalance in government finances would obviously have to be at the core of any adjustment plan, Mr. Wijnholds went on. It was disappointing to note that the authorities, despite frequent and frequently changed plans, had as yet to implement any substantive measures. The emergency plan for 1986/87, in which budgetary priorities and cost-saving measures were to be set out, remained vague; perhaps the staff could provide additional information. The imbalance in the government finances pertained mainly to current spending, which had increased since 1982 by a yearly average of 8 percent while current revenues had decreased by some 1.5 percent a year. Consequently, in terms of GNP, the current deficit had increased from 4 percent to 17 percent. That development reflected mainly the rapid increase in employment and average pay in the government sector, and the increase in subsidies, transfers, and government lending. Therefore, he fully shared the staff's observation that emphasis should be placed on a sharp curtailment of government expenditure, primarily on the wage bill, subsidies, and transfers. Efforts should also be made to increase government revenue, by both increasing tax rates and broadening the tax base. The privatization of government enterprises could make a major contribution. At present, there were about 100 such enterprises, fully or partly owned by the Government, some of which could be expected to operate more efficiently if their management was in the hands of the private sector.

A second key element of the needed adjustment had to come from an improvement in competitiveness, probably through both a decrease in unit labor costs and an adjustment of the exchange rate, Mr. Wijnholds noted. The exchange rate adjustment would have to be accompanied by stringent measures to curtail domestic demand; otherwise, the end result would merely be higher inflation. During recent years, the growth in wages had been almost twice the inflation rate, and both domestic costs and prices seemed to have become seriously out of line with those of Suriname's trading partners. Of course, he joined the staff in recognizing fully that broad-based public support for such measures was needed. Yet further delay would only increase the size of the required adjustment effort. In that context, it should be noted that, mainly as a consequence of wage and exchange rate developments, the costs of producing bauxite and its derivatives in Suriname were clearly out of line with those in other producing countries. If that trend was not reversed, a gradual phasing out of the bauxite industry--the country's main pillar of economic development--could well occur.

Suriname had a good potential for development, as a recent World Bank mission had made clear, Mr. Wijnholds stressed. Possibilities for import substitution also existed, most notably in respect of energy but of consumer goods as well. However, recent efforts at import substitution had met with only limited success, largely because of management problems. Full exploitation of the country's potential for development would require a drastic change in the authorities' policies. The existing system of controls and Suriname's lack of competitiveness was evidently limiting severely the expansion of agriculture, including forestry and fishing, and of manufacturing as well, further undermining economic activity. Only if a comprehensive adjustment program was put in place and the system of controls dismantled would Suriname be able to arrest the trends of declining exports and GNP and attract the foreign resources it needed for economic development.

Mr. Templeman said that the economic policy approach followed by the Suriname authorities since the loss of large foreign aid inflows and the decline in income from the bauxite sector had been clearly described in the staff report. While those developments might be considered to be mostly exogenous, that did not relieve the economic policymakers from the responsibility of reacting to such important changes in economic conditions. Furthermore, the continuing deterioration in the economy could also be attributed in part to domestic policy inadequacies.

The attempt to maintain domestic consumption through deliberate fiscal and monetary expansion over an extended period was increasingly worsening economic imbalances, Mr. Templeman continued. The ratio of total central government expenditures to GDP had risen significantly--from 40 percent in 1981 to 46 percent in 1985--while the development expenditure ratio had fallen by nearly two thirds from 10.3 percent to 3.5 percent of GDP. At the same time, the rapid rise in both nominal and real wages throughout the economy had added to the Government's wage bill, which had risen from less than 15 percent of GDP in 1981 to over 22 percent of GDP in 1985. The fiscal deficit itself had grown from only 3 percent of GDP in 1981 to an estimated 18-22 percent for the current year. Total net domestic assets had been growing at an average rate of 36 percent over the past three years. The growth of credit to the Central Government alone had averaged 30 percent, reflecting the nearly 100 percent financing of the fiscal deficit by the domestic banking system. Given those overly expansionary policies, it was not surprising that real growth had been negative in five of the previous six years. The consumer price index had moved up into the double-digit range in 1985 and price inflation threatened to get out of hand. In addition, the imposition of controls on prices, employment, and trade and payments, in an effort to contain excess demand, was creating serious distortions in the economy and jeopardizing future growth and development prospects.

Apparently, the bauxite sector could not be counted on for the restoration of real growth and the creation of new jobs, Mr. Templeman continued. Nonetheless, wage restraint in that sector would surely be necessary if a decline in production, income, and exports was to be avoided in that sector. The average rise in nominal wage rates in the mining sector of nearly 16.5 percent in the period 1981-84 explained to a considerable extent the financial losses being experienced in that sector. And the average rise in real labor costs of more than 6.5 percent for the economy as a whole was well in excess of any likely productivity growth and was inconsistent with long-term growth. The staff report and Mr. Kafka's statement made mention of some recent signs of wage moderation and suggested that new jobs would be created when certain new investments came on stream. While the recent legislation to strengthen job security might also strengthen the resolve of business to resist excessive wage increases, it would also restrict labor mobility. A further staff assessment of the prospects in those respects would be of interest.

The table on savings and investment on page 5 of SM/86/91 was revealing, Mr. Templeman observed. For example, the gross domestic investment ratio had fallen from 31 percent of GDP in 1981 to less than 9 percent in 1985. Even assuming that foreign aid inflows on the order of 9 percent of GDP had continued, an investment ratio of only about 17.5 percent could have been financed in 1985. Moreover, the dramatic rise in public sector dissaving--from only 2 percent of GDP in 1981 to almost 17 percent of GDP in 1985--highlighted the size of the savings/investment imbalance. Yet the private savings rate rather surprisingly had actually recovered recently.

At first glance, the ratio of the current account deficit on the balance of payments to GDP of less than 6 percent in 1985 appeared rather modest, Mr. Templeman continued. However, it was the inability to finance larger deficits that evidently accounted for that small number. At the same time, the rather modest ratio of external debt to GDP of about 11 percent could be seen as a measure of Suriname's potential to obtain foreign financing, should the authorities eventually succeed in restoring the country's creditworthiness abroad and in accelerating export growth. That was not likely to be the outcome so long as fiscal and monetary policies remained so expansionary, excess demand remained bottled up by an array of controls, exports continued to decline, and external arrears to accumulate, and the exchange rate remained fixed at its 1971 parity.

The authorities' strategy for overcoming the deteriorating economic situation called for export diversification with a corresponding relaxation of foreign exchange constraint, a recovery of real economic growth, and a reduction in the fiscal deficit, Mr. Templeman noted. But there was little in the authorities' current policy stance that was likely to create the environment and incentives for those developments to take place. The staff itself had stated that the issues discussed by the Board at the time of the 1985 consultation were the same as those under review at present. The only difference was that the situation had continued to worsen.

He strongly supported the view that Suriname could not expect an exogenous solution to its problems to emerge, Mr. Templeman concluded. While political consensus might be necessary for economic policies to be fully effective, leadership and determination might be required to achieve that consensus. Immediate implementation of a comprehensive adjustment and reform program was what the Fund staff had proposed; a similar finding had been made by the recent World Bank economic mission. The heart of such a program must be control over public spending, especially for wages and subsidies; a monetary and interest rate policy that did not so readily accommodate deficit financing and lead to negative real interest rates; and a realistic exchange rate that provided some incentive for more profitable and diversified exports, thereby allowing import and payment controls to be relaxed. That might seem to be an ambitious undertaking, but anything less was not likely to succeed.

Mr. de la Herrán commented that Suriname's delicate economic situation was well illustrated in the staff report. Over the past three years, economic indicators had plummeted to unsustainable levels. The unique structure of the economy, which was overwhelmingly based on the bauxite sector and on external aid, was without doubt responsible for a good proportion of the country's present difficulties. Nevertheless, the fact that the economy had proved vulnerable to external shocks could not hide the fact that effective measures to prevent or to partially offset such eventualities had fallen short of what would have been expected.

The situation in Suriname required the implementation of a strong package of economic measures without delay, Mr. de la Herrân said. He recognized that the broad social consensus required to carry out the necessary adjustment imposed a political constraint. Yet such a consensus could take some time to attain, and in the meantime, a widening of existing imbalances could occur. Thus, he urged the authorities to search for some formula that would permit them at least to take some measures of restraint, mainly in the fiscal area, so as to prevent the further deterioration of those imbalances.

One positive factor was that Suriname still had a relatively low level of external debt, Mr. de la Herrân observed. The authorities should take advantage of that fact and reinforce the export sector by investing in new, diversified export-oriented activities. Such a strategy would involve structural changes, which were by definition time consuming; therefore, it would be equally important for Suriname to regain competitiveness through prudent management of the exchange rate, but without excluding the need to introduce measures aimed at reducing domestic costs.

In sum, while he welcomed Suriname's choice of a medium- and long-term strategy, which would certainly have the desired results, he also wished to convey to the authorities the need to apply some more drastic, short-term oriented measures, Mr. de la Herrân concluded. By doing so, they would signal a change for the better in previously deteriorating trends that could trigger more favorable expectations and thereby bring badly needed financial resources to the country.

The staff representative from the Western Hemisphere Department noted that the emergency plan of the authorities, which had first been shaped in 1980 and updated yearly since, had been described to the staff as essentially a catalog of the objectives that the authorities would like to accomplish. The budget being prepared at that time for 1986 had not contained either any specific tax or revenue-raising measures or significant expenditure cuts. While the authorities were striving to find solutions for their problems, they had not been prepared at the time of the consultation discussions to explain the specific measures they intended to take to achieve their stated objectives. For the time being, they seemed to want to rely more on direct controls over different aspects of the economy.

In that connection, the attempt to provide employment security to the labor force was such a measure of control that not only hindered labor mobility but affected the prospects for new employment, even in sectors that might be considering an expansion of activity, the staff representative noted. It was also detrimental to the financial structure of enterprises. While the authorities had shared to some extent the staff concern about such labor legislation, they had pointed to the social and political need for it. In addition, they considered that such action was called for by the generally limited mobility of labor across various economic activities owing to the mixed social and ethnic composition of the population. For instance, agricultural activities were mostly in the hands of one ethnic group, and mining activities in the hands of another.

Mr. Kafka remarked that while he would be the last to deny the extraordinarily difficult economic situation of Suriname, an objective view must take greater account of certain positive features. First, the labor force was highly educated. Second, private savings had been rising rather than falling. And third, Suriname's external debt, although it had been rising, was still very low compared to that of most other capital importing countries.

A quick recovery of the economy would thus be possible if appropriate policies could be adopted, Mr. Kafka concluded. Whether the failure to adopt those policies stemmed from a lack of awareness, consensus, or leadership, made little difference; the fact was that the basic problem in Suriname was a political one.

The Acting Chairman made the following summing up:

> Executive Directors agreed with the thrust of the appraisal in the staff report for the 1986 Article IV consultation with Suriname.
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> Directors referred to many of the concerns that had been expressed on the occasion of the preceding Article IV consultations with Suriname. While recognizing that private savings had increased, they observed that Suriname's economic and financial situation had deteriorated further in 1985 and that pressures on the price level and the parallel market had become more pronounced. It was noted that per capita income in real terms had declined by as much as one quarter since 1981. Declining bauxite revenues and sharp cuts in the inflow of foreign aid had contributed to those imbalances, but the Government's inappropriate policy response was a principal cause of Suriname's economic decline. The government deficit had increased sharply even though development spending had been further curtailed. The prolonged fall in net international reserves and the accumulation of external payments arrears showed that unsustainable imbalances had not been addressed.
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> Directors urged the authorities to adopt without delay a comprehensive program for economic adjustment. It was considered that a key element of the adjustment program would need to be the reduction of the fiscal deficit from its present level of 20 percent of GDP, with particular emphasis being placed on the curtailment of current government expenditure, especially the wage bill and current subsidies. It was suggested that some of Suriname's many public enterprises would benefit by being overhauled, perhaps through privatization. A strengthening of the

public finances would permit the tightening of monetary policy which was needed to absorb excessive domestic liquidity and to alleviate pressure on the balance of payments.

Directors expressed concern about the Government's increasing reliance on direct administrative controls and on intervention in the areas of pricing, employment, and external trade and current payments in lieu of appropriate demand management policies and measures designed to improve supply conditions. Moreover, the lack of profitability in important segments of the export sector was noted, which was in part the result of excessive wage increases and of the real effective appreciation of the currency in recent years. Although the currency had depreciated somewhat in real effective terms since the second quarter of 1985, Directors were of the view that a considerable further adjustment of the exchange rate would be needed to restore Suriname's international competitiveness and facilitate the achievement of a more viable external position without recourse to restrictions on current payments or trade.

Directors noted the efforts of the Suriname Government to seek a national consensus to address the country's problems, but expressed their concern about the delays in adopting an effective government economic policy caused in part by the delay in reaching that consensus. Directors stressed that the situation had become critical and that the medium-term outlook--despite what they saw as Suriname's significant economic potential--was bleak. They therefore urged the authorities to develop without delay a consistent strategy to restore internal and external balance and to deal with Suriname's structural problems.

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

3. TONGA - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with Tonga (SM/86/88, 4/25/86; and Cor. 1, 4/29/86). They also had before them a report on recent economic developments in Tonga (SM/86/94, 5/5/86).

Mr. Jaafar made the following statement:

The Article IV consultation with Tonga, which was concluded last February, was the first since Tonga joined the Fund in September 1985. But the discussion in the capital, Nuku'alofa, went smoothly, efficiently, and with a sense of purpose. The staff report fairly reflects that discussion. It captures accurately the current situation and prospects of Tonga, although I agree that in some areas the lack of either timely or reliable statistics had put a constraint on some of the analysis and discussion. However, in every respect, my Tongan authorities broadly concur with the staff appraisal.

The overall economic performance in 1985 was satisfactory. Tonga had by then recovered completely from the severe cyclone that had brought widespread destruction in 1982. The external payments position was strong, with reserves equivalent to about five months of imports, and with outstanding external debt equivalent to only a quarter of GDP. The debt service burden was only about 2 percent of exports. These results reflect a record of prudent fiscal and monetary management, aided by a strong inflow of private overseas remittances.

Inflation rose in 1985, reaching 35 percent, mainly owing to the substantial appreciation of the New Zealand dollar vis-à-vis the Australian dollar to which the Tongan currency, the pa'anga, is pegged. Imports from New Zealand accounted for about 40 percent of Tonga's total imports. The domestic food supply was also adversely affected by the drought during the year.

Not untypical of small island economies, the Kingdom of Tonga remains extremely exposed to a changing external economic environment. Imports, equivalent to 50 percent of GDP, have been a source of concern, as export proceeds cover on average only one fifth of the import bills. The issue arises more from the country's vulnerability resulting from its dependence on only a few export commodities, mainly coconut products for foreign exchange, apart from overseas remittances. The latter source has so far done well although questions over its reliability have been raised recently, with the subdued performances of the Australian and New Zealand economies. The traditional export sector, on the other hand, has not shown much dynamism, in part on account of sharply lower prices for Tonga's exports. In addressing this problem, the authorities recently introduced a diversification program to broaden their revenue base and increase foreign exchange earnings. Light manufacturing and tourism have been the target of recent campaigns by the Government to promote new sources of export-related activities through the building of infrastructural facilities and the provision of an industrial incentive scheme.

The related question of land tenure, which was raised in the staff report within the context of investment and agricultural promotions, is more, in my view, a cultural issue which will take time to resolve. Meanwhile, significant reforms already took place in the 1983/84 decisions by the Government to extend the duration of land tenure to 30 years and to double the maximum leased acreage per lot to 80 acres. Leases on town allotments, on the other hand, are allowed up to 99 years.

On the fiscal front, the Government took the approach of aiming for an operating surplus and of relying on foreign aid and grants for the financing of development expenditure. Such an approach, I agree, is an entirely appropriate procedure for Tonga to adopt; in the past, it helped to preserve sound financial positions for the Government. Overall surpluses were registered for FY 1982/83 and FY 1983/84 and small deficits relative to GDP for the next two fiscal years. That approach also had kept the debt burden manageable.

It appears that the aim of making wages more competitive in the public sector, so as to attract a better quality work force, cannot be faulted, although within the context of the overall budget position, it had led to a rapid rise in the Government recurrent expenditure--equivalent to 20 percent and 22 percent of GDP respectively, over the last two fiscal years. This outcome had apparently been a cause of some concern to the authorities and posed no less of a dilemma in fiscal management. The authorities would like to fully compensate their qualified Government staff in order to retain them in the service instead of losing valuable manpower to overseas employment. On the other hand, the authorities also consider it prudent for budgetary considerations to contain expenditure, particularly because of the narrow base of tax revenue. In this regard, they had sought to broaden the tax base, but with care, so as not to overly burden private sector productivity.

On the monetary front, the staff commented on the possible distortions in the saving-investment process arising from the imposition of the 10 percent interest rate ceilings on loans. The authorities did not disagree with the staff on the possible adverse impact on savings and investment but pointed out that interest ceilings had been in place in Tonga since 1936. It is also not very clear, within the context of the Tongan economy, whether the saving-investment process is responsive enough to changes in interest rates. Other more powerful forces might control the saving-investment process in Tonga.

On the point relating to the Tongan exchange rate arrangement, there are of course merits to pegging the pa'anga to only the Australian dollar. It has served Tonga well in the past. But circumstances may change, as recently when the pa'anga sharply depreciated against the Australian dollar, not directly related to the Tongan economic conditions. The appropriateness of pegging the pa'anga to a basket of currencies is not entirely excluded from consideration by the authorities; but the merit of such a move, they felt, will have to be considered together with the study on the possibility of setting up a central bank in Tonga.

In conclusion, my Tongan authorities wish to take this opportunity to express their appreciation for Fund technical assistance in the study on central banking and the forthcoming assistance on balance of payments statistics.

Mr. Romuáldez remarked that he was pleased to be able to commend the authorities, on the occasion of Tonga's first Article IV consultation, for having successfully set the economy well on the road to full recovery from the devastation caused by the cyclone of 1982. In the two years since then, real GDP had risen by a yearly average of 8 percent. The balance of payments position had been comfortable. Needless to say, he was not ignoring the fact that the coconut industry had had to cope with slower recovery; even before the cyclone, its future had been somewhat clouded by aging and diseased trees. In that connection, it was gratifying to learn that the authorities were in the process of preparing a coconut development scheme with help from the Food and Agriculture Organization.

He fully supported the authorities' search for ways to broaden the country's domestic base and thereby diversify exports, Mr. Romuáldez continued, as well as to limit government expenditure to available resources--domestic and foreign--while maintaining a comfortable level of foreign reserves. Tonga's policy on international reserves was particularly apt, given the relative instability of international prices for coconut, the major export commodity, and given also the fickleness of tourists' preferences, tourism having already begun to have a significant impact on Tonga's annual foreign exchange earnings.

For the most part, the authorities were moving in the right direction in terms of their development objectives, Mr. Romuáldez considered. He well appreciated that Tonga's system of land tenure was deeply rooted in its culture, and he could therefore understand the preference for a gradual approach to reform in that sector. However, in two other policy areas--those concerning the exchange rate and interest rate--an early decision to make adjustments might be necessary if the authorities were to achieve their objective of fostering an economic environment conducive to private sector activity. The authorities had already done well in liberalizing prices and wages, but their hesitation in accepting the staff's recommendations for exchange rate adjustment might be impeding progress in their efforts to reduce the sharp fluctuations that had characterized price developments lately.

The Tongan authorities deserved commendation for their prudent fiscal stance, Mr. Romuáldez stated. Their policy of generating a surplus in the recurrent budget and limiting development expenditure to the resources made available through foreign aid grants and loans in order to avoid recourse to domestic bank financing and external commercial borrowing was appropriate; the result had been a small surplus in the overall fiscal balance for the second year in a row in 1983/84. However, some weakening in that respect had become noticeable recently. In 1984/85, the overall balance had swung to a deficit of T$3.5 million, or 3.7 percent of GDP, and the results were likely to be similar in 1985/86, with a rise in the deficit to T$4.7 million. The growing deficit was supposed to reflect a 7 percent increase in current expenditure and an increase of 71 percent in development expenditure. In view of the extremely small size of the budget--for instance, the purchase of one aircraft had increased development expenditure by 15 percent--he recommended a return on the part of the authorities to a more prudent stance in allocating their limited resources, especially in the development budget. In that connection, he shared the view of the World Bank staff that greater emphasis should be placed on agricultural development.

Given the expected slowdown in foreign aid flows and in the growth of private remittances over the medium term, and given also the narrow tax base, the Government's fiscal guideline should be preserved and the promotion of domestic savings intensified, Mr. Romuáldez concluded, in endorsing the staff appraisal and policy recommendations.

Mr. Fox observed that the staff report for Tonga's first Article IV consultation made encouraging reading. The economy was in a quite healthy state, especially viewed against the background of the devastation caused by the cyclone in 1982. That satisfactory state of affairs owed much to both the authorities' decisive response to the crisis and their implementation since then of sound financial policies and a sensible development strategy. Moreover, the authorities seemed to be well aware of and prepared to address most of the problems highlighted in the staff report.

To emphasize some of the more important points raised in the staff appraisal, Mr. Fox referred first to the clear need for better economic statistics. The lack of data had made the analysis of current developments more difficult and was also partly responsible for the delay in issuing the fifth development plan. Therefore, he had been pleased to note that a technical assistance mission from the Bureau of Statistics had already been arranged.

Second, the operational guidelines for fiscal policy, calling for a small surplus in the recurrent budget and for limiting development expenditure to available concessional finance, were prudent and a significant factor underlying the economy's fairly sound financial position, Mr. Fox continued. It was encouraging that the authorities intended to observe those guidelines and to adopt other financial guidelines for individual public enterprises. He looked forward to a more detailed analysis of the operations of those enterprises in the next staff report. The emergence of an overall public sector deficit in 1984/85 was attributable entirely to the purchase of an aircraft, and after that one-time deterioration, the staff did not expect another significant budget deficit for 1985/86. As Mr. Romuáldez had remarked, however, the fiscal deficit did represent some slippage from the objective of achieving a small overall surplus, and tighter control of current spending, especially for wages, seemed necessary, all the more since the increase in income tax allowances had reduced the tax base. On the investment side, the authorities should reach agreement with the World Bank as soon as possible on a set of priority projects for inclusion in a core investment program.

A third problem highlighted in the staff report was the high rate of inflation, which in turn raised questions about the wisdom of linking the currency exclusively to the Australian dollar, Mr. Fox went on. He agreed with the staff that there was a case for considering a link to a basket of currences that included at least the New Zealand dollar, since New Zealand was Tonga's major trading partner. The rate of inflation also raised questions about the adequacy of interest rates and in particular about the wisdom of retaining the ceiling on lending rates. The authorities were understandably reluctant to remove that ceiling, which had been unchanged for 50 years, but he would be interested in the staff's view of the authorities' substantive argument that an increase in interest rates would have little impact on either domestic savings or bank lending. Perhaps the more important effect would be on remittances from abroad; given the dependence of Tonga's balance of payments on those remittances, it would seem crucial to keep domestic interest rates competitive with those in Australia and New Zealand.

Despite the high rate of inflation, the authorities should press ahead with their price liberalization program, Mr. Fox considered. The staff report noted that the prices of all imported consumer goods were still subject to controls, which were not however strictly monitored. The abolition of those controls were therefore unlikely to have a major impact on prices.

Tonga's external situation seemed relatively comfortable, Mr. Fox remarked. It was true that if current trends continued, a deficit on current account might emerge toward the end of the decade, and the overall situation was also vulnerable to any shortfall in external grants. But provided the authorities maintained their policy of matching expenditure to available finance and avoiding nonconcessional borrowing, there should be no major problem. Foreign exchange reserves were also at a fairly comfortable level and the guidelines restricting lending if those reserves fell below four months' of imports was a useful contingency measure. However, he would be interested to learn from the staff what a prudent reserve level was for a country like Tonga that was so vulnerable to exogenous events.

In the longer term, the economy's growth rate would depend on the enhancement of export capacity, Mr. Fox stated. In the agricultural sector, the sooner the coconut development program could be launched the better. Although he recognized the constraints on further progress in liberalizing the system of land tenure, he joined the staff in urging the authorities to continue their efforts in that area. The decision to increase foreign investment in the tourist sector was a welcome development that should improve Tonga's foreign exchange earnings from tourism.

To conclude, Mr. Fox said that he supported the proposed decision. Tonga's exchange system was free of restrictions on current payments and transfers, and like the staff, he encouraged the authorities to explore the possibility of accepting Article VIII status. He could go along with the suggested 18-month consultation cycle.

Mr. Sugita observed that the Tongan economy had largely recovered from the damages inflicted by the cyclone of 1982. Its performance in terms of economic growth and in respect of public finances and external accounts had been relatively good. The authorities were to be commended for the prudent financial policies that had helped to bring about that favorable outcome.

As an underdeveloped, small-island economy, Tonga was of course not free from problems that would have to be dealt with to permit the development of the economy, Mr. Sugita noted. First, the statistical base was weak and must be strengthened as a matter of priority. Improved financial reporting on the part of public enterprises was also required. He had taken note of the request by the authorities for a technical assistance mission in the field of balance of payments statistics. Such assistance might also be useful in other statistical fields. The plan to set up a central bank was most welcome and should be carried out as soon as possible.

Second, as far as public finances were concerned, the operational guidelines calling for the generation of a small surplus in the recurrent budget and for limiting development expenditure to the amount of resources available from abroad had served Tonga well, helping the authorities to avoid recourse to domestic bank financing and to foreign commercial borrowing, Mr. Sugita observed. That policy would have to be continued. In that respect, the recent increase in the wages of government employees was a cause of concern; even if it had been necessitated by the need to stem a drain of qualified personnel, such considerations had to be balanced against the limited availability of government revenue. The reform of the pension scheme for civil servants also required immediate implementation.

Third, referring to monetary policy, Mr. Sugita mentioned the urgent need to change the long established interest rate ceiling, given the recent acceleration in the inflation rate. As he understood it, that change could be made without waiting for the establishment of the central bank.

Fourth, with respect to exchange rate policy, it seemed that the exchange guarantee scheme with the Bank of Tonga was standing in the way of a modification of the exchange rate system of a peg to the Australian dollar, Mr. Sugita commented. However, the seriousness of the acceleration in inflation led him to wonder whether there might not be some way to overcome any technical impediments to a swift move to a peg to a basket of currencies including the New Zealand dollar.

Fifth, as far as Tonga's development strategy was concerned, Mr. Sugita observed that the immediate prospects for agricultural exports were clouded by the aging of the coconut tree population and by the proposed phasing out by New Zealand of the subsidy scheme for bananas in 1987. The replanting of coconut trees was hampered to some extent by the land tenure system, which was closely tied to the nation's social structure. Development of the tourism sector also conflicted somewhat with the traditional way of life. The choice between development and the conservation of the traditional cultural and social framework was a difficult one that many developing countries had to face. And that choice had to be made primarily by the people of the country concerned. In that respect, he noted that the authorities were actively promoting private investment in industry and tourism and that they were gradually moving toward reform of the land tenure system. The geographical setting of Tonga suggested to him that fishing might also have potential for development.

Mrs. Walker said that she was generally satisfied with the current state of Tonga's economy and the authorities' economic management, particularly since the country was beset with many of the problems common to small-island economies. The recovery from the devastation of the cyclone in 1982 had been quick owing in large part to the authorities' efforts. Analysis of recent economic trends was hampered by limited reliable data, a problem that was to be addressed through technical assistance from the Fund, more of which would be useful.

Even considering the vulnerability of the economy to exogenous developments, the current economic situation could be improved in several areas, Mrs. Walker considered. The medium-term outlook pointed to the need for cautious fiscal management in particular, as well as for the pursuit of policies to stimulate exports and to increase the efficiency of investment. Since agriculture was the dominant sector, efforts must continue to support agricultural production. As the staff had pointed out, the prospects for agricultural exports were not encouraging. Tonga should reduce its heavy dependence on one product--coconut--the price of which fluctuated widely on the world market; their plan for the coconut sector, which had been devised with the help of the Food and Agriculture Organization, and which involved intercropping coconuts with other products, should be helpful in that respect. The land tenure system obviously hindered agricultural development. While the extension of maximum lease periods for farmland and the doubling of the acreage that could be leased had been helpful, further action was necessary.

Owing to the limited growth potential of the agricultural sector, the authorities had taken welcome steps to increase private investment in industry and tourism, Mrs. Walker noted. The Government's medium-term objectives for the industrial sector, as stated in the report on recent economic developments, included the further encouragement of private sector participation. Furthermore, the authorities were planning to conduct a thorough review of the Industrial Development Incentives Act, which she hoped would continue to be an important instrument for promoting private investment. The relaxation of the system of price and wage controls that had been in place since 1947 was welcome. Improvements in the tourism sector were still needed and she encouraged the authorities to continue their efforts to promote the private sector's involvement in tourism, which could be a major source of foreign exchange. At the same time, she had taken note of Mr. Sugita's comments on the difficulties of promoting tourism in a country like Tonga.

According to the staff, the overall fiscal balance in 1985/86 was not expected to record a significant deficit, Mrs. Walker continued. Furthermore, the budget for the current year had contained a number of positive measures, including incentives to farmers to enlarge the size of their farms and to increase the utilization of idle land, as well as measures designed to enhance tax incentives for the establishment of new export industries. However, the fiscal situation still needed to be monitored carefully. She agreed with the staff that the operational guidelines that had prevented the burden that would result from borrowing on commercial terms should be maintained. Firmer control of current spending was also needed; in that respect, she welcomed Mr. Jaafar's statement that the authorities felt it prudent, for budgetary considerations, to contain expenditure and to broaden the tax base but not in such a way as to affect private sector productivity and investment. As for public sector investment, she welcomed the World Bank study of the Government's portfolio of projects and urged the authorities to consider the Bank's advice on establishing a medium-term core investment program with more emphasis on agricultural development and an attempt to align donors' aid toward the implementation of that program.

On monetary policy, credit to the private sector had slowed considerably since 1982, Mrs. Walker noted. While that slowdown had been associated mainly with weak demand, the ceiling on domestic interest rates had reduced the incentive to the Bank of Tonga to look for domestic investment opportunities. The lifting of that ceiling, to permit interest rates better to reflect market forces and compare favorably with neighboring countries, would seem to be called for. Like Mr. Fox, she would be interested in clarification of Mr. Jaafar's statement that the Tongan authorities believed that the saving and investment process might be influenced more by factors other than interest rates. While she hoped that continued technical assistance from the Central Banking Department on the establishment of a central bank for Tonga would be helpful, she agreed with the staff that the authorities did not necessarily have to wait for the central bank to be established before they attempted to achieve the objectives they sought from its creation.

Tonga's exchange rate arrangement had served it well in the past, Mrs. Walker concluded, but recent fluctuations in inflationary pressures called for serious reflection on the appropriateness of the current exchange rate policy. She commended Tonga for maintaining an exchange rate system that was free of restrictions.

Mr. Jayawardena said that he joined other Directors in commending Tonga for the prudent financial policies that it had been pursuing. Like other small-island economies, Tonga was highly vulnerable to exogenous developments, including the vagaries of the weather. The balance of payments was vulnerable, in that export earnings covered only about one fifth of imports, making the country heavily dependent on private and official transfers and service receipts for the achievement of a viable current account. Hence, it was vital for the Government to persevere with its policy of prudent financial management. The active encouragement being given to the private sector should be helpful in overcoming those difficulties.

Commenting on Tonga's current interest rate policy, Mr. Jayawardena considered that it was appropriate to take note of the experience of many other countries in the region that had at one time followed low interest rate policies. Those policies had been rooted in long-standing antiusury laws, as in Thailand, and historically low rates of inflation. But the indefinite continuance of such policies could not but push the money market outside the official or organized sector. As Tonga was considering the establishment of a central bank, its new monetary authority might wish to review the appropriateness of the current interest rate policy.

The staff representative from the Asian Department said that the ceiling on lending rates in Tonga was creating substantial distortions in the saving and investment process. Externally, the Bank of Tonga obtained a yield on investments in Australian government bonds that was significantly higher than the 10 percent ceiling, as a result of the peg to the Australian dollar and the exchange rate guarantee the Government had provided to the Bank of Tonga on its foreign exchange assets. Therefore, it was not surprising that the Bank of Tonga had preferred to invest abroad rather than lend domestically, thereby possibly impeding investment in Tonga. If domestic interest rates reflected foreign interest rates a little more closely, the Bank of Tonga would have a greater incentive to accept the risk of domestic lending, thereby enlarging the pool of savings available to domestic investors. The staff considered that such action would have a major impact on domestic investment. It was difficult to determine at the present stage whether domestic savings could be increased because the financial system in Tonga was not very well developed. Nevertheless, interest rates on domestic savings were at present in the order of 5 percent. With inflation on the order of 35 percent, interest rates were too low to encourage savings. The staff was not proposing that interest rates should be raised significantly at the present time; but some movement in the direction of offering a better yield to depositors would provide an incentive to saving in place of consumption or, for those people who had access to foreign accounts, saving locally instead of saving abroad.

It was difficult to determine the level of reserves that was appropriate for Tonga, the staff representative continued. In general, the staff agreed with the authorities' guidelines: if reserves fell below four months of imports, the Bank of Tonga was forbidden to increase its lending; if reserves fell below three months of imports, the Bank of Tonga had to cease lending, even in the amounts equal to repayments to the Bank. Reserves in the range of three to four months' of imports should be appropriate in Tonga's circumstances given the considerable variability of its export earnings. It might be noted that reserves had fallen slightly below that level when Tonga had last been obliged to draw on its reserves in the aftermath of the 1982 cyclone. However, the authorities had responded quickly by adopting strong adjustment measures. To the extent that the authorities were willing to respond promptly to exogenous shocks, Tonga's guidelines on reserves seemed adequate.

As noted in the staff report, the need for the authorities to review their exchange rate policy carefully had been discussed with the authorities, the staff representative stated. The staff had suggested that some type of peg to a basket, perhaps including the New Zealand dollar, might be necessary. At the same time, sight must not be lost of the various difficulties that a country like Tonga would encounter in operating an exchange rate system based on a basket of currencies. First of all, the appropriate weights of the various currencies in the basket would have to be assessed, which was not an easy matter. In addition, consideration would have to be given to the relative burden that various mechanisms would impose on the time of senior officials in the Government. Setting the exchange rate rigidly on the basis of a basket might not pose great difficulties but, if a more flexible approach were chosen, difficult administrative problems might arise. The appropriate course of action seemed to be for the authorities to study the issue further. In that connection, the staff had just been informed that the Government and the Bank of Tonga had reached an agreement in principle to terminate the commitment of the Government to reimburse the Bank of Tonga for its foreign exchange losses. Therefore, the Government might also be ready to reconsider its exchange rate policy.

Mr. Jaafar observed that Tonga had benefited from technical assistance, both from the Fund and from the Commonwealth Secretariat, in improving its statistical data base. The assistance provided by the Commonwealth Secretariat had included the provision of a resident expert for a number of years in order to help strengthen Tonga's Department of Statistics, which was nevertheless still in need of qualified and experienced staff. The technical assistance mission that the Fund had tentatively scheduled for May should also help to improve the compilation and preparation of balance of payments statistics. Thus, an earnest effort had been made already in the statistical field and some progress had been made.

The authorities' prudent and cautious credit policy seemed appropriate, in view of recent price developments, Mr. Jaafar remarked. If domestic credit appeared to be on the restrictive side, despite a modest increase in credit over the past year, it might become necessary to attempt to inject some stimulus to credit through interest rate changes. However, it remained to be seen whether the economy would respond to such changes. Certainly, the ceiling on lending rates might have been appropriate during periods of stable prices. The recent sharp rise in inflation meant that interest rates had become slightly negative in real terms, giving rise to the fear expressed by the staff that, if that trend persisted, it could lead to growing distortions in the savings/investment process.

The exchange arrangement under which the pa'anga was pegged at par to the Australian dollar had had the advantage of freeing the authorities from having to manage the exchange rate daily, but it had also had the serious drawback of not reflecting the domestic economic situation, Mr. Jaafar observed. It was understandable that the authorities wished to moderate the adverse impact of imported inflation, given the high import content of consumption, but the need to promote external competitiveness was of paramount importance at the present time. Another aspect for consideration was the need to reduce the dependence on imports. For operational reasons, as the staff had mentioned, the authorities were not yet sure that a move to a basket of currencies including both the Australian and the New Zealand dollars would promote stability of the rate. They hoped that the recently completed study by the Central Banking Department would help them in resolving some of the questions that a move to such a currency basket would pose.

The openness of Tonga's economy had major implications, Mr. Jaafar remarked. To a large extent, developments in the Tongan economy were determined elsewhere--mainly in Australia and New Zealand--the country's two largest trading partners. The two issues of concern to the authorities as well as to the staff were first, the fact that Tonga's exports were inadequate to cover its imports; and second, the scope for diversification. Those two issues were not unrelated. There was only very narrow scope for diversification of the economy. In agriculture, there were no obvious alternatives to coconut and vanilla bean cultivation. The production of bananas had benefited from overseas assistance but its potential for growth was not too promising. For the long run, vigorous efforts were being made to replant coconut trees with higher yielding varieties. The World Bank had placed appropriate emphasis on agricultural development, although there was also some scope for promoting light manufacturing through various incentive schemes. The growth of that relatively infant sector would depend a great deal on measures to open up the markets of Tonga's major trading partners, Australia and New Zealand in particular. Tourism had great potential but the initial cost of development would be high. International air transportation would be crucial and would require investment in larger airports, and the construction of accommodation facilities. The authorities were anxious to encourage tourism but the existence of resource constraints meant that it would take time to develop that sector.

Private remittances had been a reliable and indeed the major source of foreign exchange so far, Mr. Jaafar added. However, the authorities were concerned because it was a source of foreign exchange receipts that was outside the control of Tonga itself, depending as it did on employment and migration opportunities abroad. Another more immediate concern was the high leakage of those remittances into consumer spending on imports, as mentioned by the staff. In that respect the authorities might need to consider developing monetary and possibly fiscal instruments to channel part of the net inflow of remittances into savings and investment. A flexible interest rate policy might be one such instrument.

The Acting Chairman made the following summing up:

Directors welcomed the first Article IV consultation with Tonga and expressed satisfaction that the Tongan economy has recovered well from the devastation caused by a cyclone in 1982. The recovery has been helped by the commendable efforts of the authorities to restrain credit growth and contain government spending. Some setback occurred in 1984/85 with the balance of payments surplus narrowing and inflation picking up sharply, owing in large part to the higher cost of imports from New Zealand. Nevertheless, foreign reserves remain at a high level and the external debt servicing obligations remain manageable, with the debt service ratio being at a very low level.

Directors agreed with the thrust of the staff appraisal. They expressed concern at Tonga's dependence on imports that are financed mostly by foreign transfers. Directors encouraged the Government to persevere in its efforts to broaden the production base of the economy, improve the efficiency of investment and encourage foreign investment as well as the growth of national savings. Directors noted, in particular, the need to intensify the coconut replanting program, and streamline the investment planning mechanism. The noneconomic reasons for a gradual approach to land tenure questions were appreciated by Directors. Directors endorsed the fiscal guidelines, which call for a surplus in the recurrent budget and for limiting public investment mainly to available foreign aid resources. In that connection, concern was expressed about the recent sharp increase in budget expenditures, and it was hoped that the increase would be nonrecurrent. Directors welcomed the progress made in relaxing price and wage controls, but they thought that a more determined approach to liberalization would be desirable and that it should include a more flexible approach to interest rate policy. If domestic interest rates were more market oriented, savings, including remittances from abroad, could increase and improve the investment prospects.

Directors welcomed the prospective establishment of a central monetary authority in Tonga. They noted that the authorities intend to terminate their commitment to reimburse the Bank of Tonga for foreign exchange losses since this commitment constrains their ability to conduct foreign exchange rate policy.

In view of recent developments, including a sharp rise in price increases in 1985, Directors welcomed the authorities' intention to review the exchange rate system in order to determine whether it continues to be appropriate for Tonga.

Directors expressed support for Tonga's cautious foreign reserve and borrowing policies. They commended the authorities for maintaining an exchange rate system that is free of restrictions; the hope was expressed that Tonga would consider accepting Article VIII status.

Directors encouraged the authorities to work to improve the quality of statistics and expressed support for technical assistance as required in this area.

It is expected that the next Article IV consultation with Tonga will be held on an 18-month cycle.

The Executive Board then took the following decision:

1. The Fund takes this decision in concluding the 1986 Article XIV consultation with Tonga, in the light of the 1986 Article IV consultation with Tonga conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes with satisfaction that Tonga maintains an exchange system that is free of restrictions on payments and transfers for current international transactions.

Decision No. 8283-(86/82), adopted
May 16, 1986

4. NICARAGUA - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with Nicaragua (SM/86/78, 4/15/86). They also had before them a report on recent economic developments in Nicaragua (SM/86/86, 4/28/86), together with a staff paper on recent changes in the exchange system and an information notice on the real effective exchange rate of the Nicaraguan córdoba (EBS/86/75, 3/31/86).

The staff representative from the Western Hemisphere Department noted that the staff had been informed that an exchange rate of C$70 per U.S. dollar would be applicable to all imports instead of the rate of C$28 per U.S. dollar mentioned in EBS/86/75.

Mr. Pérez made the following statement:

I should like to express the appreciation of my Nicaraguan authorities for the well-done work of the recent Fund mission, and for the comprehensive paper the staff has prepared in relation to the 1985 Article IV consultation with Nicaragua. The mission and the resulting paper once again underscore the value that the Nicaraguan authorities attach to the consultations with the Fund regarding the design of an appropriate economic policy framework under very particular and difficult circumstances. The midyear technical assistance mission from the Fund that visited Nicaragua in 1985 to help evaluate progress in the program adopted by the authorities that year further highlights Nicaragua's cooperation with this institution. The authorities have indicated interest in repeating this midyear technical assistance mission in order to help them evaluate the appropriateness of policies adopted at the beginning of 1986 and the corrective adjustments that would be necessary to gradually redress the external and internal disequilibria facing the Nicaraguan economy.

As in previous consultations, my authorities are in broad agreement with the thrust of the staff papers regarding economic developments in Nicaragua during 1985, although they would have suggested a different emphasis as regards certain external factors that have influenced economic activity and a more in-depth analysis of the causes for the marked jump in the rate of inflation. While there is no need for me to repeat the adverse external factors that have hindered economic growth and policy formulation in Nicaragua during the last six years, it would seem appropriate to mention at least two very important events that have come to complicate things even further.

First, in May 1985 the Government of the United States declared an embargo on all exports and imports to and from Nicaragua. This embargo came after the cancellation of Nicaragua's quota of sugar exports to the U.S. market. Since most of Nicaragua's industrial installations, machinery and equipment are of U.S. origin, and a very substantial part of Nicaragua's exports have traditionally gone to the United States, the embargo has had an important negative effect on economic activity. New markets have had to be sought; new facilities arranged for handling perishable commodities; and new shipping arrangements to handle exports; all at increased costs and generally lower prices for the country's exports.

At the same time, adaptations have had to be made to machinery and equipment, hindering their efficiency, and spare parts have to be obtained at substantially increased cost from third countries. As the Board will understand, such a major disruption of import and export flows has a very costly effect on exports, on economic efficiency, and on economic activity in general. In such circumstances it should also not be surprising that Nicaragua has had to concentrate a much greater part of its foreign trade in certain countries, or group of countries, seeking not only favorable prices for exports but also a reliable source of imports. My authorities consider that these important factors should have been brought out with much more emphasis in the staff report.

Second, it must also be mentioned that during 1985 military operations against the Government of Nicaragua became much more active. This again had an important effect on resource allocation and on relevant financial variables, reducing the flexibility needed for economic policy formulation. Although the staff report refers succinctly to this situation, my authorities consider that it should also have been highlighted much more, in order to better understand developments in 1985 and the basis for the formulation of economic policy for 1986.

The economic and financial situation of Nicaragua is indeed very difficult--even critical--as evidenced by economic developments in 1985. As mentioned in the staff report, economic activity has deteriorated in the past few years, while inflation accelerated very sharply in 1985. The authorities are well aware of this situation, and in 1985 they initiated an important change in economic policy: from one based on subsidies and generalized price controls, to another based on a more appropriate reflection of relative prices and a gradual but substantial reduction of external and internal disequilibria.

In this regard, the authorities are also well aware of the limited scope that economic policy formulation has in the present circumstances in Nicaragua. In the authorities' view, the country is at war, facing a constant threat of invasion, and undertaking a process of social transformation that makes it very difficult for "normal" economic policy instruments to work in the expected "normal" fashion. Clearly the economic climate in Nicaragua is not conducive to investment, and thus a rapid and sustained increase in economic activity and exports is not possible. Both public investment and a certain degree of price and exchange controls are necessary to at least contain the continued deterioration of economic activity and to distribute the scarce available resources, especially foreign exchange. To the authorities this does not mean, however, that they should not deal with financial imbalances. In their view, the restoration of stability is an essential step in setting the basis for the renewal of economic growth in the future. Given the restrictions already mentioned and the magnitude of the disequilibria, this can only be achieved, in the authorities' view, by a gradual sustained effort in the medium term.

The acceleration of inflation in 1985 has become the main economic problem in the short run; the authorities are committed to its gradual reduction and the return to more traditional levels of inflation for Nicaragua. Although this cannot be achieved in a single year, the authorities have a more sanguine view than the staff of what can be expected for 1986. In their view, the acceleration of inflation in 1985 was largely due to the degree of price repression that had been building up in the past five years. This repression was underestimated by the authorities, who were caught somewhat unawares by an inflation rate that went much beyond what could be explained by the devaluation of the córdoba, corrective price adjustments, and salary increases. This year such phenomena are not expected to be repeated, and policies adopted at the beginning of the year are compatible with a reduction in inflation to an average of about 200 percent for 1986. While still very high, reflecting expansionary policies in some areas, such a rate would represent a reduction of about 50 percentage points in relation to the average of last year, which the authorities estimated at 250 percent. The policies to achieve such an outcome have been explained by the staff, albeit with a more pessimistic view than the authorities, and I would only add a few complementary remarks on the subject.

As the authorities see it, there are three basic forces of monetary expansion at work in Nicaragua: the fiscal deficit, credit expansion to the productive sectors, and potential or realized foreign exchange losses on the part of the Central Bank. Even though these can be grouped into one--overall credit expansion--it is convenient to consider them separately for analytical and policy purposes. My concluding comments will refer to wage and salary adjustments, also an important element in explaining inflation.

Under present circumstances, while aware of the importance of bringing the fiscal deficit down to more reasonable levels, the authorities consider that there are important limitations on reduction in the short term. Thus, the monetary authorities have concentrated on the other two elements in order to reduce monetary expansion.

Somewhat differently than what is mentioned in the staff report, the Nicaraguan authorities' figures indicate a small improvement in the central government fiscal deficit ratio in 1985. This is not an area for substantial disagreement, however. The fiscal deficit in Nicaragua is in any case very high--21 percent of GDP in 1985. But whichever figure one accepts, the fact that this deficit is being financed almost wholly by credit from the Central Bank is the main cause of the financial disequilibria. Furthermore, the authorities estimate that a little over 50 percent of current expenditures are related to defense, and almost 85 percent of such expenditures are concentrated in four ministries: defense, interior, health, and education--the first two directly related to the defense effort of the country, and the last two aimed at improving the basic welfare of the population. Given the high priority afforded by the Government to these areas, one cannot be optimistic about a major reduction of the fiscal deficit in the short term.

The rigidities mentioned should not be interpreted to mean that the authorities will not make efforts to rationalize and adjust the fiscal effort as much as possible. In that regard, strict control will be maintained over nondefense expenditures, and new revenue measures are being implemented, although they are not of a sufficient magnitude to achieve a reduction in the deficit larger than the goal of 10 percent of GDP mentioned in the staff report. Adjustments have already been made in certain selective consumption taxes, and a major change has recently been made in the assessment of import duties to reflect the actual exchange rate used in import transactions. This recent change has set the "free" exchange rate as the basis for the liquidation of customs duties. The authorities expect a substantial revenue yield from these measures, and are more optimistic than the staff regarding the attainment of positive results. Other measures have been mentioned by the staff and are already being applied.

To redress imbalances, albeit gradually and under the restrictions mentioned above, the Central Bank of Nicaragua is playing a greater role in the stabilization effort through a much more active policy than in the recent past. In 1986, minimum legal reserve requirements have been re-established which, coupled with the introduction of a discount and rediscount system for bank credit, should allow a much more active control of credit expansion and recovery to productive sectors. At the same time, credit controls have been extended to the National Investment Fund (FNI) in order to reduce central bank financing of this agency. In this regard I should mention that the authorities have made important cuts in FNI's investment plan, reducing its financial requirements.

In 1986, loan interest rates were adjusted substantially. While real interest rates remain highly negative, the authorities expect to adjust such rates in part by implementing flexible annual adjustments in nominal interest rates, but more importantly by a substantial reduction in the rate of inflation. If, as expected, average inflation is reduced by 50 percentage points, this will have a marked effect on real rates which would not have been viable to achieve by increases in nominal rates. In any case, adjustments to nominal rates should be based on the expected rate of inflation and a gradual correction of the present negativity of real rates.

As mentioned by the staff, a major objective of the 1986 economic program is a further simplification of the exchange system with a view to achieving a more realistic relative price structure, and to eliminating or substantially reducing potential exchange losses to the Central Bank.

The exchange rate policy being implemented by the authorities, in their view, takes objectively into account a crucial element of Nicaragua's situation: a climate that is not conducive to stability. According to the authorities, in such circumstances it would be difficult, not to say impossible, to determine a fixed equilibrium rate. On the other hand, a floating rate approach, given these uncertainties and the scarcity of foreign exchange, could only lead to very rapid, large, and unstable movements in the exchange rate that would complicate economic management even more and would be the cause for new disequilibria. Thus they have opted for a system of a fixed (and at present overvalued) exchange rate, combined with a floating element provided by the "free market." This should help to promote exports while adjusting more discretely the price of imports, thereby reducing pressures for wage price increases. In the authorities' view, perseverance with this policy--of large annual adjustments in the fixed rate, and the transfer of a large proportion of transactions to the free market--should bring the córdoba gradually to a more realistic value, thus helping to construct a more appropriate relative price structure.

Wages have been an important cause for monetary expansion, especially in 1985. It should be mentioned, however, that real wages in Nicaragua have been declining steadily. For the present year, the authorities are committed to no further wage increases than those approved in January and March. In this regard, the authorities are well aware that large increases in nominal wages to compensate for exchange rate and price adjustments is not the appropriate way to safeguard the interest of the workers. While there will be adjustments in nominal wages in the future, it is expected that these will not be granted more frequently than annually, and in a magnitude that would not completely compensate for exchange rate adjustments. The authorities have indicated that they have no plans to establish a policy of wage indexation.

Mr. Arias noted that the substantial deterioration in the public accounts in 1985 had followed a decline in tax revenues, which had been preceded by a strong increase in the previous three years. Expenditures had been kept unchanged but there had been a substantial slowdown in capital outlays, and the elimination of subsidies on basic consumer goods in 1985 was being offset by increases in wages, and spending on social services and defense. The complexity of the tax system indicated the need for its simplication and for improvement of the tax base. He felt sure that the authorities could profit from the Fund's technical assistance in the tax field, especially with respect to improving tax revenues.

Monetary policy had been designed to accommodate fiscal policy, Mr. Arias observed. As a result, the rate of inflation had increased significantly, reducing domestic incentives to save. Real interest rates had remained highly negative, and credit was being allocated by administrative decision.

The sharp devaluation of the official exchange rate for most transactions had been a step in the right direction, and the scope of the so-called free exchange rate had also been increased, Mr. Arias commented. However, much remained to be done. The rapid increase in domestic prices had almost doubled the real effective value of the córdoba compared with its end-1980 value. It seemed to him that the Nicaraguan authorities should follow the example of other high-inflation countries and adopt a flexible exchange rate policy instead of making large devaluations from time to time.

The staff seemed to be unhappy because the authorities were determining prices and profits on the basis of mark-ups over average cost, Mr. Arias remarked. He agreed that that might not be the best pricing policy but it had certainly enabled public enterprises producing goods for domestic consumption to generate operating surpluses for the first time since 1980. A pricing policy based on marginal costs might be more efficient from the point of view of resource allocation, but it would require complex calculations and administrative machinery that was not available in Nicaragua. Profits under the system adopted by the authorities were preferable to large deficits, in his view, although he would welcome the staff's comments.

Mr. Nebbia observed that the continued accumulation of large domestic and external imbalances by Nicaragua had to be analyzed in the context of a civil war that had left much of the infrastructure of the economy damaged, guerrilla activity that had drained the public finances as a result of defense-related expenditures, and the sharp depression in prices on the world market for its exports together with a declining demand for goods shipped from Nicaragua, particularly since the imposition of the U.S. trade embargo.

The fiscal situation had deteriorated sharply in 1985, Mr. Nebbia said. The increase in defense-related expenditures by 13 percent of GDP since 1981 and the cost of improving public health services and education might explain a large part of the fiscal deficit, which had jumped from 12 percent of GDP in 1981 to 21 percent in 1985. Those imbalances had been increased because of Nicaragua's limited access to external resources. The financing of those large deficits by the Central Bank had made it totally impossible for the monetary authorities to control the money supply.

Therefore, he welcomed the intention of the Government to reduce the overall fiscal deficit by 5 percentage points of GDP in 1986, Mr. Nebbia continued. However, owing to the large imbalance in the fiscal accounts, stronger action was required, both through an increase in revenue and a reduction in expenditures. The re-establishment of minimum reserve requirements, the introduction of stricter lending procedures, and the raising of interest rates were welcome measures. It was important for Nicaragua to attain positive--or at least neutral--interest rates in real terms to improve resource allocation and to foster financial savings, although he agreed with the authorities that those objectives should be sought both through an increase in real interest rates and a substantive reduction in the rate of inflation. It had occurred to him to wonder whether a market could be developed for public bonds, with the aim of financing the public deficit as well as improving the control of the money supply. The share of the public sector in total GDP did not seem excessively high, particularly if it was compared with that in other Latin American and European countries.

Real wages had declined by more than 50 percent in the past five years, in both the public and private sectors, as shown in Table 8 of SM/86/86, Mr. Nebbia continued. Therefore, it could not be argued that wage policy had pushed up inflation. The increased cost of basic food products, as well as the devaluation of the córdoba, seemed to have been largely responsible for the upward leap of the inflation rate in 1985. In evaluating the impact of the devaluation, it was necessary to take into account the large share of tradables in the price index, with exports and imports accounting for about 50 percent of GDP. It would be helpful if the staff could comment, in particular, on the reason for an inflation rate in 1985 that was almost ten times higher than the rate in 1983 and in 1984, whereas the fiscal deficit had been kept constant during those three years.

The recent changes in the exchange system were commendable, Mr. Nebbia observed, although he believed that further steps in that direction, together with an improvement in the fiscal accounts, would strengthen Nicaragua's external position. In sum, Mr. Nebbia reiterated that in dealing with a country that was facing a very unsettled political and military situation, a necessary condition for the solution of most of its economic problems would be a peaceful, negotiated solution to the conflicts in the area.

Mr. Engert said that it was clear from the staff report that Nicaragua had experienced deteriorating economic conditions over the past several years, for a number of reasons, including an adverse external environment and a difficult political and security situation. However, unsound economic policy had been an additional major factor.

The efficient use of resources should be of paramount importance to Nicaragua, given its difficult circumstances, Mr. Engert observed. To achieve it would require an institutional framework that conveyed information provided in a market-oriented system on the availability and use of resources. Although recent steps had been taken by the authorities to adjust consumer prices and remove elements of subsidization, they had generally moved away from a market mechanism in the past few years. The authorities' attempts to moderate prices, increase the role of the public sector, and keep aggregate demand at high levels had simply resulted in an acceleration of the rate of inflation and a deterioration in economic activity.

Although he understood the motivation of the authorities in attempting to ensure a certain minimum living standard by adjusting wages, he urged them to consider the misallocation of resources that resulted from the failure to take into account supply and demand conditions in the economy. The large-scale suspension of the price mechanism in recent years had contributed significantly to Nicaragua's economic difficulties. The establishment of a more flexible price mechanism in the goods, labor, and financial markets would make a major contribution to improving Nicaragua's growth prospects.

A particular example of relative price distortions was the exchange rate of the córdoba, Mr. Engert noted. The exchange rate system appeared to be administratively complex and did not provide effective incentives to economize on scarce foreign exchange or to improve the external balance that a more flexible, liberal system would. Moreover, as the staff had indicated, the recent devaluations of the córdoba had tended to be offset by the inflationary effects of expansionary demand management policies, resulting in an overall real appreciation of the córdoba and undermining Nicaragua's ability to improve its external performance. He endorsed the staff view that a more flexible and realistic exchange rate policy was a necessary, although not a sufficient, condition to improve Nicaragua's balance of payments and creditworthiness. Such a flexible exchange rate policy needed to be supported by restrained fiscal and monetary policies in order to diminish inflationary pressures. In that connection, he agreed that wage increases should not be linked to past inflation rates but should be determined with reference to objectives of future disinflation, which again would require prudent and credible fiscal and monetary policies.

At the root of Nicaragua's accommodative monetary policy was the large and growing fiscal imbalance of the public sector, particularly the Central Government, Mr. Engert observed. The staff had indicated that the authorities intended to reduce the overall cash deficit of the Central Government in 1986 but that the planned reduction would result in only a moderate decrease in inflationary pressures. Perhaps most important, however, was the fact that over the previous three years, the fiscal balance had been much worse than originally planned. As a result, and given the authorities' resolve not to cut defense-related expenditures, the outlook for fiscal improvement was not good. Therefore, he encouraged the authorities to re-examine their fiscal policy, with a view in particular to decreasing nondefense expenditures.

On specific issues of monetary policy, Mr. Engert said that he agreed with the staff that the practice of relending resources obtained from reserve requirements should be ended and that central bank advances to the public sector and to the National Investment Fund (FNI) should be curtailed. Interest rates should be determined in a more realistic and flexible manner, preferably with a market orientation, and should be allowed to increase so as to afford savers an attractive return and promote a more efficient allocation of capital. By keeping interest rates below market clearing levels, the effective constraint on investment was the lack of savings. Moving toward the market-clearing interest rate would tend to increase both savings and investment.

In concluding, Mr. Engert drew attention to the medium-term outlook presented in the staff report suggesting bleak prospects for the Nicaraguan economy for several years ahead. He believed that the outlook would improve greatly if the Nicaraguan authorities implemented many of the staff's recommendations, including in particular greater reliance on the price mechanism, a realistic and flexible exchange rate policy, and a prudent orientation of fiscal and monetary policy.

Mr. Wijnholds said that economic developments in Nicaragua had continued to be disappointing, showing negative economic growth coupled with very high inflation and a huge deficit on current account. The staff had estimated external arrears at no less than US$1 billion. The country was, of course, engaged in a military struggle, which no doubt highly complicated economic management. At the same time, however, economic policies seemed to have contributed importantly to the unfavorable results recorded. The authorities had taken a number of measures in 1985, and again early in 1986, that pointed in the right direction but that unfortunately were either insufficient or not accompanied by the other measures needed to address the serious problems effectively.

After 1979, the economy had become a mixed one, implying a greater role for the state in the economic process and increased importance for public enterprises, Mr. Wijnholds continued. He had been pleased to note that the public enterprises were maintaining a combined operating surplus, although the state foreign trade companies, which were not included in the public sector, were experiencing sizable deficits owing to the guaranteed producer price system. It was also commendable that the authorities had eliminated consumer subsidies in 1985. However, as in some other mixed developing economies, price and exchange rate policies had not been conducive to a good export performance in the past. Given the openness of the Nicaraguan economy and its relatively large import needs, that was serious cause for concern. The fall in exports in 1985 to the lowest level since 1979 had, of course, also been due to important exogenous factors, such as poor harvests, and the shrinkage of the Central American Common Market--factors mentioned by the staff--as well as the U.S. trade embargo--which had been mentioned on page 10 of the staff report but only as a reason for the authorities' pessimistic outlook on exports. He would appreciate further information from the staff on the effects of the unfortunate shrinkage of the Central American Common Market and the U.S. trade embargo.

The recent adjustments in the exchange rate had been necessary to offset the serious erosion of Nicaragua's competitive position, Mr. Wijnholds remarked. Unfortunately, the devaluations had not been accompanied by measures to restrain demand, and large wage increases had been awarded. The result of that policy approach had been a strong inflationary impulse. The staff had stated that "the recent devaluation will need to be followed by further action along these lines...," but it had also stressed that, at the same time, demand management and wage policy should be adequately restrained. Although he agreed with the thrust of those remarks, he would be inclined to reverse the order of the policy prescription. In other words, priority should be given to bringing domestic demand and wages under control. Otherwise, further adjustment of the exchange rate would only add to the already highly inflationary climate.

A move to a flexible exchange rate policy might prove to be the only way to maintain competitiveness, but unless it was preceded or accompanied by strong internal adjustment, Mr. Wijnholds stressed, it would be tantamount to capitulating to rampant inflation. In that light, he strongly endorsed the staff's warning against linking wage increases to past inflation and was encouraged to learn from Mr. Pérez's statement that the authorities did not, in fact, intend to introduce wage indexing. It also followed from what he had already said that the huge budget deficit should be reduced and monetary growth curtailed. The authorities had been taking some steps in those areas but the staff judged them to be insufficient; based on past experience, its assessment was likely to be correct.

The projections relating to the medium-term external outlook were discouraging, Mr. Wijnholds observed. The financing gap was enormous and could not be filled except by sizable increases in arrears. However, the outcome might be somewhat less alarming, although still very unfavorable, if the assumption that no debt relief would be granted from 1986 onward was too pessimistic, as it might be. He asked the staff to explain the reasons for that assumption.

All in all, Mr. Wijnholds concluded, Nicaragua faced difficult times ahead. Its economic fate in future years would be determined in large part by external forces, but that did not mean that the country could not do more--in fact, much more--to improve its domestic situation.

Mr. Salehkhou noted that the authorities had continued to be preoccupied during 1985 with further defense activities in the increasingly hostile external environment. The country's human and financial resources, which potentially could have been mobilized to remove economic rigidities and counter inherited structural distortions, had been utilized mainly to respond to external threats. That situation, together with the adverse impact of the trade embargo and suspension of credits from traditional sources, had depleted Nicaragua's international reserves and forced the Government to have further recourse to the banking system to meet its financing needs, as explained in Mr. Pérez's statement.

Notwithstanding the implementation of some corrective measures, the continuation of expansionary fiscal and monetary policies, coupled with negative real output and export growth, had led to an unsustainable rate of inflation in the economy and a further deterioration in the balance of payments, Mr. Salehkhou added. Despite that unfavorable trend and severe shortages of foreign exchange, the authorities had discharged Nicaragua's overdue financial obligations to the Fund, and their intention to pay future SDR charges on time in order to remain current with the Fund was equally commendable.

During 1985, the authorities had introduced a set of corrective measures to cope with increasing imbalances, Mr. Salehkhou observed, including the devaluation of the córdoba, the simplification of the exchange system, with a widening of the free exchange market, an increase in the number of controlled prices, and the elimination of consumer subsidies. In spite of a considerable increase in defense-related expenditures, which had almost doubled to about 21 percent of GDP, total expenditures had remained unchanged at about 60 percent of GDP in 1985 owing to the elimination of government subsidies and substantial cutbacks in capital outlays and some social services. Nevertheless, the overall deficit of the nonfinancial public sector had increased by 3 percentage points to 24 percent of GDP in 1985 as a result of the decline in total fiscal revenue. Therefore, central bank credit had been expanded greatly in 1985 in order to finance the public sector deficit.

On the external side, the weak export performance had continued in 1985 as a result of poor coffee and cotton harvests and the shrinkage of the Central American Common Market, while imports had increased moderately through the disbursement of tied loans from friendly governments, Mr. Salehkhou noted. Along with an increase in interest payments, the consequence had been a widening of the current account deficit to US$0.9 billion, and financial arrears had continued to accumulate, reaching about US$1 billion at the end of 1985, an amount equivalent to three years' export earnings.

For the year 1986, the authorities' intention to curb the overall central government deficit by about 5 percentage points to 19 percent of GDP was commendable, Mr. Salehkhou stated. The measures contemplated in order to increase revenue were a step in the right direction. However, he shared the staff's view that a reduction in the deficit was unlikely to be achieved and that monetary policy would continue to be expansionary. Despite the introduction of a special incentive scheme and other recent measures to favor exports, the scope for promoting traditional exports was limited owing to depressed world market prices--except for coffee--the U.S. trade embargo, and sluggish demand in the rest of Central America. Therefore, the overall economic prospects for 1986 seemed less than promising.

In sum, he had been strengthened in his view at the time of the 1985 Article IV consultation that "as long as the prevailing hostilities by foreign and domestic elements persist, there will not be much that the authorities can undertake to avert the prevailing crisis situation," Mr. Salehkhou declared. The suspension by the World Bank of disbursements on existing loans and the virtual cutoff of funds by multilateral financial institutions and commercial banks had not only worsened the existing imbalances but had also contributed to the accumulation of arrears. Taking into account the regional hostilities and their implications for the economy of Nicaragua--namely, the need to allocate additional financial resources for defense-related outlays that already amounted to one third of total public expenditures--he wondered how the implementation of the corrective measures proposed by the staff, such as a substantial depreciation of the exchange rate and a liberalization of pricing policies, could suffice to help bring the economy back on track. Surely, that totally market-oriented prescription was not a remedy but rather would lead to a strengthening of the existing inflationary pressures. His chair was of the opinion that such corrective measures could be effective only when hostilities ceased.

Mr. Finaish noted that, as described in the staff report, the economic situation in Nicaragua was indeed very difficult, marked as it was by declining national output, large domestic and external imbalances, high inflation, and severe debt service problems. To be fully understood, that situation must be seen against the background of the unsettled political and security conditions and the adverse external environment faced by the country in recent years. The persistence of an unsettled political and security situation had put severe pressure on the country's finances, limited the authorities' policy options, and more generally had given rise to an environment that was inimical to efforts to bring about orderly adjustment and recovery. At the same time, the external economic environment had not been favorable to Nicaragua as it had been marked by depressed demand and weak prices for most of the country's exports and the suspension of foreign credit from some traditional sources. Nicaragua also had had to contend with the effects of a trade embargo imposed by a previously important trading partner.

Those factors had played a major role in the deterioration of Nicaragua's economic situation in recent years, Mr. Finaish remarked, and while the staff had mentioned them as having contributed to the increased economic difficulties, as Mr. Pérez and other Directors had mentioned, they seemed to have been given less than their full weight in the staff analysis. The implications of those factors, which had conditioned economic performance and constrained economic management, could have been brought out more fully. While those factors had been quite important, weaknesses in economic policies had also contributed to the deterioration in the economic situation, although it should be remembered that some of the policy weaknesses themselves reflected in part the pressures created by those same adverse factors.

The staff had usefully drawn attention to policy areas where corrective action was needed, Mr. Finaish continued, foremost among them being the need to reverse the deterioration in the fiscal position. While the military situation had made it difficult to reduce defense-related expenditures, more effective control could be established over other categories of government expenditures. In the current year, the authorities should seek to ensure that at least the targeted reduction in the overall fiscal deficit relative to GDP was achieved. Additional revenue and expenditure measures would need to be taken in following years, of course, since the targeted outcome for 1986 would still leave the overall deficit at a high level. Moreover, measures to improve the efficiency and financial performance of public enterprises could be strengthened.

The growth of domestic liquidity would have to be slowed substantially if the strong inflationary pressures were to be contained, Mr. Finaish added. In that respect, he noted that the authorities had recently taken some measures to strengthen control over the extension of credit. While those measures were useful, they would not be adequate to bring about the needed degree of restraint in credit growth without an accompanying reduction in the large public sector borrowing requirement and in the expansion of credit by the banking system to meet that requirement. In addition, interest rates needed to be adjusted further to bring them more in line with the rate of inflation.

The adjustments to administered prices and the exchange rate during 1985 and 1986 were steps in the right direction, Mr. Finaish considered. As a result of the substantial adjustments in prices, consumer subsidies had been eliminated. The movement toward rationalization of the domestic price structure should be sustained. With respect to exchange rate policy, as the staff had emphasized, appropriately sized adjustments in the exchange rate needed to be combined with adequately restrained demand management and wage policies so that nominal exchange rate adjustments, instead of feeding an inflationary spiral, were translated into the desired improvement in competitiveness.

Commenting on developments in wages, Mr. Finaish said that, while the staff was certainly correct in calling for the exercise of appropriate restraint in wage determination and for the avoidance of a wage policy that acted to feed a wage-price spiral, its description of actual developments in wages in the staff report could have been clearer and more precise. The staff report tended to convey the misleading impression that wages had been more or less fully adjusted to the actual increase in the price level, thereby broadly maintaining their real value. As shown in Table 39 of the report on recent economic developments, covering the period 1981-85, real wages in both the private and public sectors had fallen continuously, reaching one half of their 1981 value by 1985.

If Nicaragua's economic problems were to be tackled effectively and fully, a comprehensive adjustment and recovery effort would be required, Mr. Finaish stated. Such an effort would consist of a substantial tightening of macroeconomic financial policies, structural adjustment to improve resource allocation and mobilize additional resources, and appropriate levels of new investment for reconstruction and development. Given the magnitude of existing imbalances, the required adjustment effort would have to be sustained over a period of several years. A particularly important condition for an orderly process of adjustment and recovery would be an improvement in the country's political and security situation. Furthermore, to sustain the required adjustment effort, Nicaragua would need appropriate external financial support. Arranging that support would remain difficult as long as financial flows from some traditional sources, including certain multilateral institutions, remained suspended. It should also be clear from the medium-term outlook described by the staff that, without an appropriate restructuring of its external debt, Nicaragua's debt service and arrears problems would continue to be severe and obstruct the normalization of relations with creditors. It remained true, of course, that for its part Nicaragua should make all possible efforts to settle its external arrears at an early date. In that context, the settlement of overdue obligations to the Fund in 1985 had been a welcome step, which had also served to demonstrate the importance attached by the authorities to maintaining a good cooperative relationship with the Fund.

In sum, political and security conditions permitting, what Nicaragua needed for an effective and orderly resolution of its difficult domestic and external financial problems was a comprehensive medium-term framework for adjustment supported by the necessary cooperation from the international financial community, Mr. Finaish said. The Fund had a potentially constructive and helpful contribution to make in carrying out that task.

Finally, Mr. Finaish asked the staff whether it had discussed with the authorities the possibility of a drawing under the compensatory financing facility, since the export figures suggested that Nicaragua had experienced a significant export shortfall in 1985. He would also appreciate further background information on the World Bank's relations with Nicaragua since 1980, when the last economic mission from the World Bank had taken place, the last Bank loan to Nicaragua having been approved in early 1982, long before the country had incurred arrears to the Bank in the latter part of 1984.

Mr. Templeman recalled that during the discussion of the staff report for the 1985 Article IV consultation with Nicaragua, concern had been expressed in the Executive Board about relative pricing in the broad sense and about continued laxity in controlling aggregate domestic demand. There had been particular concern about the exchange rate and the foreign exchange system, large fiscal deficits, rapid monetary expansion, sharply rising nominal wages, very large deficits in the current account of the balance of payments, and the continued accumulation of arrears. While a few measures had been taken since then, the economy was in worse condition than it had been a year before in virtually every major area. Real economic growth had fallen from a negative 1 1/2 percent in 1984 to a negative 2 1/2 percent in 1985; the rise in consumer prices through the year had accelerated from 50 percent to 334 percent; nominal wages in the private sector had increased from a rate of 14 percent in 1985 to one of 158 percent; the current account deficit of the balance of payments had risen from 25 percent to 31 percent of GDP; the public sector deficit--including unpaid interest, deficits of the state foreign trade enterprises, and exchange losses of the Central Bank--had increased from 30 percent to 34 percent of GDP; and net domestic credit had risen by about 178 percent compared to 102 percent. In sum, the economic deterioration had been steady and across the board.

As he had noted, Mr. Templeman continued, a few corrective measures had been taken in 1985 and in 1986 to date. There had been two exchange rate devaluations and some modification of the exchange system; controlled prices had been adjusted and consumer subsidies eliminated; somewhat greater flexibility had been shown in wage adjustments, especially for higher-income managerial employees; the central government deficit target in 1986 had been set about 5 percentage points lower than for 1985 and some measures had been taken to raise revenues; limits had been placed on cash holdings of government agencies in public enterprises; bank reserve requirements had been reintroduced; and deposit and lending interest rates had been raised by 10-20 percentage points. All of those measures had gone in the right direction but they had fallen well short of a comprehensive and coherent program of economic adjustment.

The staff's medium-term balance of payments projection suggested clearly that the overall economic situation was apt to continue to be unacceptable and, in some respects, to worsen, Mr. Templeman observed. For instance, even with real GDP growing by only 1-2 percent per annum in 1987-90, the current account deficit of the balance of payments would average nearly 30 percent of GDP throughout the rest of the decade; the ratio of public medium-term and long-term external debt would rise from 161 percent of GDP in 1985 to 202 percent in 1990; the debt service ratio would peak at 222 percent of exports of goods and services in 1986 and still be at nearly 150 percent in 1990. Furthermore, the continued accumulation of external arrears would constitute the principal source of residual balance of payments financing, with arrears of US$3.7 billion accumulating in the 1986-90 period--on top of US$1 billion in arrears outstanding at the end of 1985.

The staff report contained a number of explicit or implicit policy recommendations on how the Nicaraguan authorities might begin at least to improve on their presently inadequate economic policy management and economic performance, Mr. Templeman noted. Those recommendations included a further devaluation of the córdoba to offset the still high real effective rate in comparison with earlier years; supporting measures to exercise much stronger restraint on domestic demand; more flexible pricing policies; elimination of the controls on profits that did not reflect the relative efficiency of the enterprise; a wage policy tied to a future inflation target rather than to past inflation; fiscal measures to provide greater assurance that the target for the central government deficit of 19 percent of GDP could be achieved in 1986; more flexible and realistic positive interest rates; firm application of the bank reserve requirements and cuts in credit to the Central Government, the state foreign trade enterprises, and other public enterprises. Eventually, some fundamental structural reforms would no doubt also be required.

In conclusion, Mr. Templeman stated that it was obvious that without a more comprehensive and internally consistent program of economic adjustment and structural reform, the deterioration in the Nicaraguan economy would not only continue but was apt to accelerate. The breadth and rigidity of government controls seemed to be stifling current economic growth and preventing the creation of incentives that might offer promise of a more acceptable rate of growth with financial stability over the longer term. Negative public savings of 16 percent of GDP in 1985 and dependence on foreign savings in an amount equal to 31 percent of GDP--in large part via the accumulation of external arrears--testified to the seriousness of the domestic and external imbalances that needed to be dealt with.

Mr. Vasudevan noted that the economic performance of Nicaragua was a matter of concern because it had been disappointing for two years in a row. It was therefore essential for that performance to show considerable improvement in 1986, making the need for policy action crucial. In working out policy measures in 1986 it was only natural to judge them on the basis of their likely efficacy in the light of experience, in particular in the recent past. The staff appraisal left the impression that the authorities' assessments had been good in general and that the actions taken so far had been in the desired direction. For instance, the devaluation of the córdoba in February 1985 and again in February 1986 had been welcomed by the staff, as had the elimination of consumer subsidies as a result of adjustments in the domestic prices of some basic commodities. The staff had also welcomed the monetary policy measures taken in February 1986, such as the re-establishment of minimum legal reserve requirements, the introduction of strict lending procedures, and the raising of deposit and loan rates. But the staff had nevertheless found the policy measures taken so far in those areas to have been insufficient to meet the objectives. In addition, the staff had not approved of the wage increases and the high fiscal deficits; besides, it doubted the possibility of reducing the fiscal deficit in 1986 to the extent targeted.

There was indeed much merit in the staff's arguments, Mr. Vasudevan noted, but it was useful to recognize that the authorities had undertaken corrective measures during 1985 and so far in 1986, to the extent possible, given the constraints imposed by the political situation and the external environment. That situation was epitomized in Mr. Pérez's statement, and the staff itself had acknowledged that guerrilla activity and the shortage of labor had had some effect on agricultural export crops. Manufacturing activity had suffered on account of the shortage of imported inputs. Revenues had declined, partly owing to the fall in output and partly to the reduced volume of trade, while defense-related expenditures had increased sharply. The fall in commodity prices in international markets and the inhospitable external environment had affected the volume of exports. Not all those developments had been induced by endogenous factors.

Mainly because of the large fiscal deficits and the resultant monetary expansion, Mr. Vasudevan added, the inflation rate had touched a high level of 219 percent on an average basis during 1985 compared with a rise of 35 percent in 1984. The authorities had tried to reduce the erosion of the purchasing power of workers by increasing nominal wages but by a lower percentage than the percentage rise in prices. As a result, average real wages in both the private and public sectors had declined in 1985, as Table 8 of the report on recent economic developments showed. Apparently, the staff had not been opposed to the wage increases granted in 1985 but had been more skeptical of those granted in early 1986 because they ran the risk of leading to a policy of wage indexation, a legitimate concern. Thus, he had been glad to note from Mr. Perez's statement that the authorities had no plans to establish a policy of wage indexation.

As for the likely fiscal outcome in 1986, the authorities planned to reduce the central government deficit by about 5 percentage points of GDP through revenue measures, including increases in selective consumption taxes, improvements in tax collection, and changes in the assessment of import duties to reflect the actual exchange rate used in import transactions, as well as by expenditure restraint, Mr. Vasudevan went on. However, the authorities had acknowledged the difficulty of restraining defense-related expenditures; they had also allocated large sums to health services and education, as Mr. Pérez had stated. If there were no serious supply bottlenecks or shortages, there was no reason why the contemplated revenue measures should not give rise to the expected increases in revenue. In any case, the authorities were not optimistic about a major reduction in the fiscal deficit in the short run. Certainly, the fiscal imbalance would render economic management difficult in future years.

On the monetary policy front, the staff suggestion to terminate relending to the financial system by the Central Bank in order to restrain monetary expansion was well worth pursuing, Mr. Vasudevan considered. According to Mr. Pérez, the authorities did not expect a substantial reduction in the inflation rate in 1986, even once the recent credit controls were applied. That was bound to be a matter of concern since it would have implications for resource allocation as well as for economic welfare. The staff had suggested that interest rates should be pushed up further to become positive in real terms, and the authorities intended to implement annual adjustments in interest rates. Yet the role of interest rates was not clear. For instance, it was intriguing to find that the expansion of quasi-money had been high in 1985 in spite of a negative real rate of return on bank deposits. He would appreciate comment by the staff on that issue.

Referring to the external sector, Mr. Vasudevan remarked that the further devaluation suggested by the staff had limitations in view of the low share of nontraditional exports in total exports--about one fifth of the total--and the prevalence of multiple rates. In the circumstances, the impact of a further devaluation on external competitiveness was uncertain and the result might be further inflation. The impact might also be affected by the U.S. embargo on Nicaraguan trade. In fact, an assessment of the actual and potential impact of that embargo would be helpful in evaluating Nicaragua's future trade and growth prospects. As the staff had shown, the medium-term outlook appeared difficult. It was not necessary to agree with all the assumptions underlying that exercise--for instance, the implied growth rate--to realize that Nicaragua would need debt relief on a large scale sooner than might be imagined if its exports continued to be sluggish and imports picked up as projected, and in the absence of flows from traditional sources of external financing. The policymakers in Nicaragua therefore had to be alive to their problems and accept the challenge of future uncertainty with courage and imagination.

The staff representative from the Western Hemisphere Department explained that the staff disagreed less with the authorities' strategy for setting producer prices--since all producers should be paid a sufficiently remunerative price to provide them with a certain profit--than with the way in which the strategy had been implemented. Under the existing policy, the authorities calculated a basket of average costs of a selected group of producers, in both the private and public enterprise sectors, to which they added a markup to allow for a profit. The problem arose from the inclusion in the basket of both efficient and inefficient producers. Some producers in the so-called People's Property Area that were included in the basket were seminationalized enterprises which had been recording large cost overruns owing to generally poor administration and high production costs. The losses of those public enterprises were covered either by transfers from the Central Government, or loans from the Central Bank and the commercial banks. The incorporation of such enterprises in a basket that served as a benchmark removed any incentive for them to improve their management, preventing them from becoming efficient, profit-making enterprises.

There were at least five factors underlying the great difference between inflationary pressures in 1985 and the two preceding years, the staff representative continued. First of all, price controls on some basic commodities and public services had been dismantled in 1985. The sharp increase in the controlled prices of basic foodstuffs, fuel and public utilities by about 150 percent, on average, had been a necessary corrective measure but it had had a large impact on consumer prices in 1985. Second, the large fiscal deficit and the expansionary monetary policy had had an additional impact on prices. While the fiscal deficit had ranged from 21 percent to 25 percent of GDP on a cash basis, on an accrual basis--including all domestic arrears and the losses of the Central Bank--the public sector deficit was about 34 percent of GDP. Monetary expansion in general, including credit to the foreign trade enterprises and to the People's Property Area, had also continued to increase at a rapid pace.

Large wage adjustments over a period of a few months had been a third element affecting prices in 1985, the staff representative said. A wage increase of 40 percent in February 1985 had been followed by a 20 percent increase in March and a 47 percent increase in April. The staff was concerned that the policy of granting large wage increases was continuing in 1986, with a 90 percent increase in January and an additional 50 percent increase in March. In earlier periods, wage increases had been lower and had been distributed over a longer time span. It had been a source of concern to the staff to learn that prices had increased by 79 percent during the first three months of 1986. The January 1986 increase in wages, which had been announced in December, had resulted in an increase in prices of about 15 percent before the end of December. Clearly, there was a direct correlation between the upward adjustment of wages, expectations of inflation, and rising prices.

The shortage of products was a fourth factor underlying the increase in prices during 1985, the staff representative commented. In 1983, Nicaragua had still been able to import goods. At the present time, many commodities had disappeared from the marketplace, and the dwindling supply of goods had been reflected in domestic price increases. A fifth and related factor was the closed nature of the Nicaraguan economy. Because Nicaragua was unable to import goods owing to a lack of foreign exchange, expansionary policies and any kind of excess demand had to spill over into prices because it could not spill over into the balance of payments. In previous years, the balance of payments had still offered an escape valve to some extent.

It was almost impossible to determine how much of the 300 percent increase in prices in 1985 could be attributed to any of those specific factors, the staff representative noted. No doubt a combination of those and possibly other factors had been responsible.

The possibility of the Central Government tapping private savings by issuing bonds to finance the government deficit had been discussed with the Nicaraguan authorities, the staff representative mentioned. However, the authorities had been somewhat reluctant to issue private savings bonds, which would have to carry an adequate interest rate. The central government deficit had been financed by the Central Bank, but with credit carrying no interest rate at all, and the authorities had been fearful about increasing the deficit, especially as an arrears problem was beginning to emerge. However, the issuance of bonds would be a possible instrument for future use, especially with a view to increasing domestic savings.

Exchange rate devaluation was not a solution to the basic problems of the country, unless domestic policies were adequate, the staff representative noted. The adjustment strategy should address the domestic imbalances first, with devaluation being part of the package of adjustment measures. The fact that the recent exchange rate modification had not been accompanied or preceded by other appropriate policies had resulted not only in the loss of some of the favorable impact of the devaluation, but had also contributed to an exchange rate that was once again inadequate. In addition, if the purpose of the exchange rate adjustment was to provide an incentive to exporters, that objective could not be achieved because the extent of the devaluation was insufficient to ensure a remunerative price to producers. Consequently, the Central Government, state enterprises, or the Central Bank had had to assume the fiscal burden of financing subsidies for producers.

So many uncertainties attached to the medium-term scenario that the projections should be viewed with great caution, the staff representative observed. Basically, the purpose of the exercise was to demonstrate the consequences of the continued pursuit of certain policies. It could not be foreseen whether, in the three years ahead, Nicaragua would have to cover its substantial financing gap through some form of debt rescheduling or, in the absence of such rescheduling, would be forced to accumulate additional arrears or make even more severe cuts in domestic economic activity. Although, the staff had attempted to quantify the medium-term scenario, it was to be noted that the margin of error in the projections might be very large. Rather than stressing the actual figures, the staff would emphasize that the projections showed that the medium-term scenario was very bleak and offered little prospect for Nicaragua to pull out of its difficulties without an inflow of foreign assistance, in the form of either additional loans or debt renegotiation.

Although the Nicaraguan authorities had tentatively mentioned the possible use of Fund resources, the issue had not been pursued further and the staff had received no statistical information on the possibility of an export shortfall in 1985, the staff representative explained. Of course, the staff would look at any request from the authorities for use of the Fund's resources under the compensatory financing facility on its merits, in accordance with the guidelines established by the Executive Board for use of that facility and for the calculation of the export shortfall.

With respect to Nicaragua's relations with the World Bank, the staff representative from the Western Hemisphere Department recalled that there had been a number of informal missions since the early 1980s, the last visit by the staff of the World Bank having taken place in February 1986. No new loans had been negotiated since March 1982, but loans that had been extended previously had continued to be disbursed. The basic problem was the accumulation of Nicaragua's arrears to the World Bank. At the beginning of 1982, the arrears had been covered by allocating loan disbursements as payments to the World Bank. Once those disbursements had been fully utilized, additional arrears had accumulated. As of May 15, Nicaragua's arrears to the World Bank amounted to US$54 million. An additional US$10 million would fall due during the second half of 1986. Subsequently, repayments would fall due at the rate of about US$10 million each semester.

Another staff representative from the Western Hemisphere Department added that another possible factor underlying the sharp acceleration of inflation in 1985, which was related to the policy of monetary expansion, was the overhang of excess liquidity that had built up over the years. As prices were decontrolled in early 1985, that liquidity had spilled over into higher prices, which had increased by the end of the year by about 320 percent, whereas wages had increased during the same period by 146 percent.

While it was true that the growth in quasi-money had accelerated from 60 percent in 1984 to 90 percent in 1985, in real terms it had declined, the staff representative said. Compared with the growth of GDP, the increase in quasi-money in 1985 was in fact illusory.

The main reason for not including any assumption of debt relief in the medium-term projections was the need to have some idea of the outlook on the basis of reasonable assumptions, especially in light of the difficulties inherent in making medium-term projections for a country like Nicaragua, the staff representative added. The authorities had made no mention of possible debt relief in the years immediately ahead at the time of the most recent mission, compared with previous missions, and the staff had had to take that fact into consideration. Furthermore, debt relief over the past two years had amounted to about US$100 million, mainly in the form of a formal one-year deferment of obligations to commercial banks.

The shrinkage of the Central American Common Market had been a factor in the decline of Nicaragua's exports, but not the only one, the staff representative from the Western Hemisphere Department observed. Other Central American countries that had adjusted their exchange rates to realistic levels had done well in exporting to other members of the Common Market, whereas Nicaragua had had more difficulty in maintaining its market share because of its overvalued currency. It was obvious that the trade embargo had had an adverse effect on the economy of Nicaragua, but not so much with respect to exports; the possibility of sugar exports had already been foreclosed by earlier events, and exports to the United States, mainly of beef and bananas, had amounted to only about US$25 million in 1985. The authorities had explained to the staff that exports were being redirected to other countries, but at lower prices and at higher cost, because of increased transportation costs. The impact of the embargo had been felt more on the side of imports, which had been on the order of US$90 million in 1985. The difficulty of obtaining spare parts from the usual sources had affected the growth of manufacturing output more than had been expected. In fact, the negative growth of 2 1/2 percent of GDP in 1985 was in large part to be explained by the significant decline in manufacturing output.

The Executive Directors agreed to resume their discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/86/81 (5/12/86) and EBM/86/82 (5/16/82).

5. YUGOSLAVIA - STAND-BY ARRANGEMENT - WAIVER OF PERFORMANCE CRITERIA

1. Yugoslavia has consulted with the Fund in accordance with paragraph 4 of the stand-by arrangement for Yugoslavia (EBS/85/85, Sup. 3, 5/1/85) concerning the nonobservance by Yugoslavia of the performance criteria pertaining to the signing of bilateral agreements with official creditors before March 25, 1986 and to the limits on the growth of expenditures of the public sector in the period ending March 31, 1986, in order to reach understandings with the Fund regarding the circumstances in which purchases by Yugoslavia may take place under the stand-by arrangement.

2. The Fund decides pursuant to paragraph 4 of the stand-by arrangement for Yugoslavia that notwithstanding the nonobservance of certain performance criteria, Yugoslavia may proceed to make purchases under the stand-by arrangement. (EBS/86/107, 5/9/86)

Decision No. 8284-(86/82), adopted
May 14, 1986

6. ITALY - 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 Italy to not later than July 2, 1986. (EBD/86/139, 5/8/86)

Decision No. 8285-(86/82), adopted
May 12, 1986

7. TOGO - TECHNICAL ASSISTANCE

In response to a request from the Togolese authorities for technical assistance in the area of tariff policy and domestic indirect taxes, the Executive Board approves the proposal as set forth in EBD/86/144 (5/12/86).

Adopted May 14, 1986

8. APPROVAL OF MINUTES

(a) The minutes of Executive Board Meetings 85/127 through 85/131 are approved. (EBD/86/140, 5/8/86)

Adopted May 14, 1986

(b) The minutes of Executive Board Meetings 85/132 through 85/134 are approved. (EBD/86/142, 5/9/86)

Adopted May 15, 1986

9. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/86/108 (5/9/86), and EBAP/86/111 (5/12/86), and by Advisors to Executive Directors as set forth in EBAP/86/108 (5/9/86) and EBAP/86/111 (5/12/86), is approved.

APPROVED: February 5, 1987

LEO VAN HOUTVEN
Secretary