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Minutes of Executive Board Meeting 86/123

10:00 a.m., July 28, 1986

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	K. Yao, Temporary
	E. L. Walker, Temporary
	K. Celebican, Temporary
	A. H. Mustafa, Temporary
	K. Murakami, Temporary
	W.-R. Bengs, Temporary
Huang F.	
J. E. Ismael	
A. Kafka	H. A. Arias
	J. Hospedales, Temporary
	R. Fox, Temporary
	I. Puro, Temporary
	O. S.-M. Bethel, Temporary
	A. Abdallah
	J. J. Dreizzen, Temporary
	L. P. Ebrill, Temporary
	R. Valladares, Temporary
	G. Nguyen, Temporary
	J. de Beaufort Wijnholds
	B. D. White, Temporary
G. Salehkhou	
	A. Vasudevan, Temporary
	F. Di Mauro, Temporary

J. W. Lang, Jr., Acting Secretary
J. K. Bungay, Assistant

Also Present

Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director. Fiscal Affairs Department: K.-Y. Chu. Legal Department: J. K. Oh. Western Hemisphere Department: S. T. Beza, Associate Director; A. P. De La Torre, J. Fajgenbaum, J. Ferrán, C. M. Loser, S. C. de Sosa, S. J. Stephens. Personal Assistant to the Managing Director: R. M. G. Brown. Assistants to Executive Directors: J. R. N. Almeida, B. Tamami.

1. TRINIDAD AND TOBAGO - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with Trinidad and Tobago (SM/86/161, 7/3/86). They also had before them a report on recent economic developments in Trinidad and Tobago (SM/86/172, 7/15/86).

Mr. Hospedales made the following statement:

My authorities are grateful to the staff for the detailed and comprehensive analysis of recent economic developments in Trinidad and Tobago and also for the assessment of medium-term prospects. For the most part, they agree with the thrust of the staff's findings and recommendations and, therefore, I shall simply elaborate on my authorities' perspectives on certain key policy matters.

Since the latter part of 1981, my authorities had recognized very clearly the need to adjust the domestic economy to take account of the incipient decline in the real price of oil. Accordingly, over the next four years, 1981 to 1985, overall economic policy, in the main a combination of demand management and structural policies, served to correct major imbalances that had emerged in the economy. As a result, in 1985

- the overall fiscal deficit fell to 7.1 percent of GDP, an improvement over the 9.3 percent in 1984 and 13.7 percent average in 1982/83;

- the current account deficit of the balance of payments improved to less than 1 percent of GDP, compared with an average of 9.0 percent over the three-year period 1982-84;

- net international reserves declined by only US$242.8 million, compared with US$735.1 million in 1983 and US$975.8 million in 1984. However, the level at December 31, 1985--US$1,130.0 million--was still considered adequate to provide cover for approximately nine months' imports;

- the rate of inflation decelerated to approximately 7.7 percent, the lowest rate since 1972;

- wage and inflationary expectations were brought into line with the current economic reality and the outlook for the economy.

While the country's self-imposed adjustment program was successful in achieving internal and external financial balance, significant adverse consequences flowed from the measures adopted. In 1985, real GDP fell by 3.7 percent, making the average annual decline 5.5 percent over the period 1983-85. Of major concern was the performance of the non-oil economy, which declined by 7.7 percent, the average annual decline in the three-year period 1983-85 being 7.6 percent. In the process, the unemployment rate increased from an annual average of 11.9 percent in the period 1983-84 to 15.5 percent.

In the view of my authorities, however, conditions at the end of 1985 were appropriate to a change in the mix of policy to give emphasis to the stimulation of economic activity while protecting the gains that had been won in the process of adjustment. The focus on stimulating the economy was therefore not at the expense of continued fiscal discipline. Accordingly, the 1986 budget saw a continuation of the process of rationalizing and extending indirect taxation, and control of government expenditure, so that over the medium term both the fiscal and balance of payments deficits would be sustainable. To underpin the adjustment efforts, and in particular to strengthen performance in the sectors for traded goods, the exchange rate for the Trinidad and Tobago dollar was devalued by 33 1/3 percent against the U.S. dollar; but in an effort to alleviate in the short term the effects of the large exchange rate adjustment, the previous rate continued to be applied to imports of certain basic commodities. At the same time, the 10 percent tax on sales of foreign exchange for travel abroad and emigrants' remittances was eliminated. The primary purpose of the devaluation was to enhance the competitiveness of the Trinidad and Tobago economy, particularly nontraditional activities that had been granted significant incentives in recent years to improve machinery, plant and equipment, and to secure new export markets.

However, the collapse in the price of oil since January 1986--a development not anticipated even by those closely associated with the oil market--severely undermined the foundations of growth that had been carefully laid over the past four years. My authorities share the view that the considerable uncertainties prevailing in the world oil market preclude confident predictions of near-term movements in the price of oil. Nevertheless, they recognize that it is prudent to plan on the basis that the price may remain at relatively low levels over the foreseeable future. Accordingly, they are committed to introduce supplementary measures of budgetary restraint so as to restore long-term fiscal balance by removing the structural gap between available revenue and national spending decisions.

As far as 1986 is concerned, immediate steps are being taken to contain the adverse effect of the fall of the price of oil, although it is clearly not possible to absorb, virtually instantaneously, a loss in real income of approximately 13 percent of GDP. As a result, expenditure control will become increasingly stringent to ensure that the enforced enlargement of the deficit can be accommodated through an appropriate mix of domestic and foreign borrowing. It is to be noted that by June 1986, government expenditure on a cash basis was TT$2,978.7 million, compared with TT$3,256.5 million in the same period of 1985--a decline of more than 15 percent in real terms. On the other hand, government revenue in the comparable periods was TT$2,948.9 million and TT$3,152.6 million, respectively. In other words, expenditure control has resulted in a situation where the budget is practically in balance in the first half of 1986, despite the fall in revenue over the comparable period of 1985, and, therefore, the fiscal targets could be achieved for the year as whole.

Notwithstanding the need for further significant adjustment implied by the recent fall in oil prices, my authorities remain committed to the commencement of a process of selective and careful stimulation of the economy to restore the growth process and mitigate the unemployment situation. In this regard, my authorities have recently reduced reserve requirements on the commercial banks in order to alleviate the extremely tight liquidity situation which had been obtained over the last few years. Further, the terms of installment credit have been relaxed in order to increase the scope for competitive forces with respect to consumer credit, while selective credit controls have been retained to ensure that the balance of payments does not deteriorate, owing to credit-driven pressures. The effects of these measures are being continuously monitored and a full formal review will take place early in the fourth quarter.

The country's trade balance has remained in surplus (US$162 million in January-April 1986), reflecting in part the positive impact of the devaluation. The surplus on the merchandise trade account has, however, not been large enough to offset the continuing deficit on the services account. As a result, the country has continued to lose reserves. The loss of reserves has been exacerbated by the unwinding of trade credits as importers sought to take advantage of the previous exchange rate for shipments effected prior to the devaluation. At the end of June 1986, the loss of reserves amounted to US$350 million, compared with US$305.1 million in the same period of 1985.

The recent collapse of oil prices precipitated the need for further severe adjustment. My authorities are aware that the conditions attending the current adjustment effort are far less propitious than the circumstances associated with the initial effort over the 1982-85 period. However, given the fact that internal and external financial balances are now more nearly in line and expectations similarly adjusted to a less favorable economic outlook, my authorities are confident that the recent external shocks can be overcome and the growth process reinitiated. To do this successfully and within a reasonable time frame, enhanced access to long-term capital will be required. In this regard, the terms and conditions of access to commercial markets are becoming more stringent so that it is even more urgent for Trinidad and Tobago to be in a position to obtain long-term funds in adequate amounts from the multilateral development agencies.

Mr. Fox observed that the authorities of Trinidad and Tobago had combined a major fiscal retrenchment with a cautious wage policy to bring about considerable progress in recent years in adjusting to the decline in oil revenues that had begun in 1981. Most economic indicators, except growth and employment, which remained weak, had registered improvements in 1985. The authorities were now faced with having to effect a further substantial adjustment because of the renewed fall in oil prices, while trying concurrently to reverse several years of declining output. They were to be commended for having moved quickly to address the new situation, in particular, with the devaluation in December 1985, and more recently, with the establishment of a commission to review public spending and revenues. The adjustment efforts of the past two or three years had perhaps relied too much on fiscal retrenchment, notably a sharp reduction in public capital spending, accompanied by import controls, and the retrenchment might have resulted in a larger decline in output over that period than need have been the case. In contrast, the improvement in competitiveness brought about by the devaluation would help to shift resources to the external sector and to reduce the reliance of future adjustment on expenditure cuts.

Although the exchange rate adjustment of December 1985 had been an important move toward a more realistic exchange rate, the dual rate system created its own distortions, and he urged the authorities to unify the system at the earliest opportunity, Mr. Fox stated. One of the authorities' reasons for exempting "essential" imports from the devaluation was because of the effect that those exemptions might otherwise have had on the upcoming wage negotiations. A continuation of the authorities' successful policy of wage restraint was essential. However, it was noteworthy that those exemptions did reduce the impact of the devaluation on producer incentives, notably in the agricultural sector, which worked against the objective of promoting non-oil growth, particularly in the agricultural sector.

The authorities maintained that the devaluation had restored competitiveness if recent improvements in labor productivity were taken into account, Mr. Fox noted. If possible, the staff should indicate whether relative unit labor cost data showed a better picture than did relative prices, which remained 20 percent above their 1978 level. Even if current competitiveness was adequate, it would not necessarily remain so, depending on future movements in relative prices and costs, and he urged the authorities to adopt a more flexible attitude to the exchange rate and to be ready to adjust it as necessary to maintain their recent gains in competitiveness. It would be helpful to know what the exchange rate assumption had been in the staff's medium-term projections.

The commission to review public revenue and spending was potentially an effective first step in the adjustment of public finances to reduced oil revenues, Mr. Fox indicated. It was also quicker than waiting for a thoroughgoing review of the budget, although as the staff had noted, such a review would be essential in due course, and he wondered what progress had been made to that end. He was slightly concerned that too much was being asked of the commission--namely, to reduce expenditure by 7 1/2 percent on average, compared with 1985, and by about 25 percent compared with budgeted levels--without the backing of a formal budget. Therefore, the figures cited by Mr. Hospedales, which showed expenditures running below the 1985 level, had been useful. It would be helpful to have comments from the staff on how far developments in the first half of 1986 went toward meeting the objective of a consolidated public sector deficit of 12 1/2 percent of GDP, and whether that was adequate.

Adjustments to public enterprise tariffs merited further action at an early stage, Mr. Fox remarked. He wondered whether there was scope for postponing public capital spending, currently budgeted to rise by 40 percent in 1986. Although investment had fallen substantially in recent years and further declines should be avoided if at all possible, investment levels would depend on the success of efforts to restrain current spending and to increase revenue, and it would be helpful to know the composition of the measures taken thus far in 1986.

The authorities should endeavor to introduce an appropriately stringent budget, including both expenditure-reducing and revenue-raising measures, as soon as possible in 1987, with a view to achieving the objective of reducing the consolidated public sector deficit to 4 percent of GDP by 1988, Mr. Fox stated. The authorities' intention to reduce expenditure further if the oil price fell below $18 a barrel was welcome. He asked what the Trinidad and Tobago oil prices currently were, and what the average price had been thus far in 1986.

He endorsed the staff recommendation that the authorities should work toward positive real interest rates on deposits as a means of encouraging private savings and a stronger balance of payments, Mr. Fox said. He also shared the staff's concern about a reduction in reserve requirements at the end of June 1986, together with some other measures. Staff comments on the latest package would be helpful.

In conclusion, he could support the proposed decision, including the nonapproval of exchange and import restrictions, Mr. Fox commented. He urged the authorities to develop a timetable to eliminate those restrictions as soon as possible.

Mr. Dreizzen remarked that the recent collapse in the price of oil had introduced an element of high uncertainty and risk vis-à-vis the successful achievement of the goals that the authorities had been seeking through the pursuit of adjustment policies over the past four years. It was instructive to compare the Chairman's summing up at the conclusion of the previous Article IV consultation with Trinidad and Tobago (EBM/85/68, 5/1/85) with economic developments in the country before the collapse in the oil market.

Three major policy suggestions had been included in the summing up, Mr. Dreizzen noted. The Board had urged the authorities to continue reducing the public sector deficit. In 1985, the public sector deficit had continued to decline steadily, thanks to the authorities' major efforts on the expenditure side, and that deficit had been halved in a period of two years. The Board had also encouraged the authorities to increase the real interest rates for deposits. The average real interest rates for deposits had moved from -6.5 percent in 1984 to -0.4 percent in 1985. Finally, the Board had noted that the real effective exchange rate had appreciated substantially, and that there was a need for a depreciation of the currency, to be followed by appropriate policies of wage restraint to reduce its inflationary effects. In December 1985, the authorities had adjusted the value of the Trinidad and Tobago dollar downward by 33 percent, vis-à-vis the U.S. dollar. Moreover, cautious wage policies had been pursued both in the public and private sectors, including reductions even in nominal wages. In sum, the authorities had shown their strong commitment to adjustment, and they had carefully taken into account the Fund's advice.

However, the dramatic decline in external receipts, caused by the fall in oil prices, had sharply exacerbated the internal and external imbalances of Trinidad and Tobago in 1986, Mr. Dreizzen continued. Despite the authorities' adoption of stronger corrective measures, the staff projected that in 1986, real GDP would decline by 4.2 percent, the deficit in the public sector overall balance in relation to GDP would reverse its declining trend and reach 12.6 percent, while the external current account deficit would be 6.6 percent of GDP. Trinidad and Tobago illustrated once again the key role that the external environment played in the success of adjustment programs in developing countries. Most of the improvements that the authorities had obtained through adjustment policy measures had been offset partially or totally by the deterioration in external conditions.

He fully agreed with Mr. Hospedales that it was not possible to absorb virtually instantaneously a deterioration of the terms of trade that meant a loss in real income of about 13 percent, Mr. Dreizzen stated. The authorities should pursue an optimal path of adjustment, both in terms of speed and timing. Such a course required an adequate mix of finance and adjustment in order to eliminate imbalances without extensive, unnecessary harsh effects on economic activity and the living standards of the population. He shared the concerns of Mr. Hospedales that if the terms and conditions of access to commercial banking finance became more stringent, Trinidad and Tobago would require long-term funds from multilateral lending agencies to finance the structural reforms needed by the country. Finally, he supported the proposed decision.

Mr. Bethel observed that the staff papers (SM/86/161, 7/3/86 and SM/86/172, 7/15/86) had detailed clearly the past trends in the economy of Trinidad and Tobago that had led to the present situation and required fiscal realignment. In fact, the necessity for adjustment was not unknown to the authorities, as several measures currently in question were those that had been taken precisely to decrease the impact of declining world oil prices during 1979-83. Having achieved one of the highest growth rates in the Caribbean community during the period of high oil prices, and justifiably having expanded both the industrial base and infrastructure to meet the demands of the country, the authorities should appreciate the necessity of taking adequate measures at present to preserve what had been achieved in the past, and to provide a sound base for future growth. The authorities' commendable determination toward that end was evidenced by the measures taken to reduce aggregate expenditure and restrain wages.

A reduction in capital expenditure over the past three years, particularly in 1985, had assisted in the decrease of the overall budget, Mr. Bethel noted. The completion of most of the major infrastructural work should allow capital expenditure to be kept at a minimum. However, he encouraged the authorities to pursue actively other areas of expenditure reduction, such as in the public enterprises and utilities, and with that objective in mind, he commended the authorities for the establishment of the commission to monitor more closely and frequently both expenditure and revenue. Any preliminary observations or conclusions of the commission, particularly in the light of the staff's medium-term fiscal plan, would be of interest.

The authorities should exercise caution in the introduction of any new tax scheme, inasmuch as approximately 53 percent of total revenues were nonpetroleum revenues, 33 percentage points of which were derived from taxes on income, Mr. Bethel advised. There was clearly a risk that the tax burden of the private sector would be increased, and, along with a lack of financial resources due to high goverment expenditure, restrict the private investment necessary for growth. He therefore encouraged the authorities in their efforts to enhance the tax collection procedures, and agreed with the staff's suggestion to delay initiation of an income tax reform.

However, an increase in revenue must be complemented by a decrease in transfers to the public enterprises and utilities, Mr. Bethel went on. There was a need for efficiency in those operations, and he encouraged the authorities to implement the measures necessary to make them viable, self-supporting enterprises.

The authorities' concern about the low incentive for savings within the private sector was justified, Mr. Bethel considered. The authorities had taken measures recently with regard to commercial bank credit and reserve requirements, but he wondered whether those measures would not encourage more consumer expenditure than saving. The incentive to save would be enhanced by an attractive deposit rate and by confidence in the stability of the financial institutions. Measures taken in that regard and others taken to strengthen the stock exchange as an avenue for private investment should have positive results. The response to the Unit Trust Corporation indicated the necessity and importance of such an entity to attract small savers, who represented a large proportion of the population.

The dual exchange rate was no longer an effective instrument for price control on essential imports, given the distortions that it created, Mr. Bethel stated. Moreover, it restricted the effectiveness of an advisable devaluation that would be desirable. Therefore, he encouraged the authorities to consider unification of the rates at the earliest moment. The impact of unification on trade and the allocation of resources should be evident, thereby encouraging diversification away from petroleum. Diversification of the economy should focus on export-oriented enterprises that would foster productivity and efficient utilization of the available labor force. The authorities should also actively pursue an expansion of trading partners.

Noting the trend of the public sector external debt over the past several years, Mr. Bethel advised the authorities to monitor the increase closely, particularly so as to avoid the "bunching" of maturities. The authorities had decided wisely to give preference to borrowing from regional and multilateral institutions, although the authorities' preference might be restricted by the possibility of being graduated from one of the World Bank funds. However, in view of the decline in real per capita income in recent years, the staff might comment on whether the World Bank graduation might be reviewed, and might elaborate more generally on the effects of the graduation process on countries with volatile economies, such as Trinidad and Tobago.

The authorities had clearly identified problems and the necessary measures to resolve them, Mr. Bethel concluded. They had also set about implementing those measures, although there was room for further action on exchange restrictions, and he supported the staff recommendation in that regard.

Mr. Valladares observed that Trinidad and Tobago continued to show economic imbalances, despite the authorities' efforts to cope with the economic difficulties caused by the decline in the international oil market. The adjustment measures introduced in recent years had resulted in an improved balance of payments, but the decline in oil prices had affected the performance of the economy, challenging the authorities to adopt more comprehensive measures in all sectors.

It was noteworthy that the overall public deficit had continued to register a declining trend in 1985, Mr. Valladares continued. The decrease of 2 percentage points of GDP had been attained mainly by a reduction of capital outlays, the elimination of subsidies on oil products, and an improvement in the finances of the rest of the public sector through rate increases for public utilities and transportation.

With respect to the public sector overall balance, the authorities had shown a welcome commitment to efforts to generate increased government revenues, but they should act cautiously in implementing measures, given the decline in economic activity. However, it would be advisable for the authorities to review their capital expenditure policies, with a view to curtailing current expenditures by a sufficient margin to allow increases in capital expenditures, so as to establish conditions for sustainable long-term growth. To complement the measures taken in the fiscal area, the authorities had opted to follow a tight monetary policy in 1985. That policy had helped to reduce the level of inflation, to close the gap between the deposit and lending rates, and to limit the loss of reserves.

The vulnerability of Trinidad and Tobago to developments in the international price of oil had led the authorities to adopt preventive measures to avoid further deterioration of the external sector, Mr. Valladares remarked. As a consequence of those measures, the current account deficit in relation to GDP had declined by 6 percentage points in the period 1984-85, reflecting an improved overall balance of payments deficit of about US$250 million in 1985, down from the US$750 million recorded in 1984. The authorities' efforts to diversify their exports were noteworthy--in 1985, the non-oil export sector had registered an increase, and the authorities should continue to pursue diversification policies.

As Mr. Hospedales had stated, the adjustment program imposed by the authorities had been successful in accomplishing a number of economic improvements, Mr. Valladares noted. Nevertheless, those measures had resulted also in a reduced level of economic activity, as reflected by a real decline in GDP and by the increased rate of unemployment. Thus, it was important for the authorities to implement careful and adequate measures in order to attain positive results.

Trinidad and Tobago was highly dependent on exports of oil and any exchange rate movements would have only a limited impact on export performance in the short run, whereas the effect on domestic prices would be overemphasized because of the weight of imported products in the cost of living basket, Mr. Valladares pointed out. The two-step approach followed by the Government to adjust the exchange rate of the Trinidad and Tobago dollar to the new economic situation was therefore understandable. The phaseout of the lower exchange rate in the future would permit a smooth transition to the new exchange rate by alleviating the short-term effects of the sharp adjustment on basic commodities.

The authorities should take into account fluctuations in the international price of oil and adopt policies that would move the economy toward general equilibrium, Mr. Valladares considered. It would be crucial for them to monitor closely the effects of the measures to be taken in order to achieve the medium-term targets envisaged in an adjustment process that would result in sustained economic growth.

Mr. Vasudevan remarked that the economic situation of Trinidad and Tobago reflected the sharp change in incomes brought about by the steep drop in the prices of oil and oil-related products over the past four to five years. Prompted by falling oil revenues, the cuts in government expenditures since 1982--especially those of a capital-creating nature--had also contributed to considerable declines in real output of the nonpetroleum sector. The unemployment rate had risen in recent years, and the share of gross national savings in GDP had been lower in 1985 than in 1981.

On many accounts, however, the performance of Trinidad and Tobago in 1985 could be termed as satisfactory, Mr. Vasudevan continued. Although real GDP had declined by about 17 percent on a cumulative basis in the four-year period, 1982-85, the cumulative deterioration in the terms of trade of 11 percent over the same period had had a considerable influence on output, largely because of the fall in oil and oil-related product prices. The public sector fiscal deficit and external current account deficit had been reduced, in proportion to GDP, by about 2 percentage points and 6 percentage points, respectively. Moreover, monetary expansion and price increases had decelerated.

The sharp cuts in public expenditures, increases in the rates of public utilities, and the virtual elimination of most subsidies on oil products had helped to bring about a reduction in the fiscal deficit in 1985, Mr. Vasudevan commented. The improvement in the current external payments position had been effected by severe cuts in imports, which in turn had been prompted by reductions in domestic expenditures and the application of exchange and import restrictions. The deceleration in the rate of inflation reflected the reduction in aggregate expenditures. It was also attributable partly to a marked deceleration of wages, owing mainly to the authorities' firm stance in the wage negotiations for 1984-86. The deceleration in monetary expansion had resulted in part from higher bank reserve requirements, a slowdown in economic activity, and the reduction in aggregate expenditures.

The staff's medium-term outlook for Trinidad and Tobago, based on the assumption of an oil export price of US$16 a barrel for 1986, was obsolete, given the recent collapse in international oil prices, Mr. Vasudevan indicated. Nevertheless, the staff had pointed out that policies would need to be strengthened if oil prices declined more sharply. It was therefore clear that the fiscal and external current account deficits would rise significantly in 1986, regardless of the specific figures given in the staff report.

The authorities' plan to cut expenditures in accordance with the targeted fiscal deficit was a useful way to start, in view of the high share of non-oil tax revenues in GDP, Mr. Vasudevan said. However, beyond 1986, the authorities seemed prepared to consider raising revenues by tax collection and reforms, including the introduction of a generalized sales tax. He broadly agreed with that approach. The authorities were also committed to raising the rates of the public utilities over time. The public utilities had already been receiving a lower amount of central administration transfers in 1984 and 1985 than previously. However, a medium-term plan to improve the efficiency of the units would be needed to cover their operating costs.

The authorities had tackled the issue of the large spread between deposit and lending interest rates, first by lowering the reserve requirements, and by relaxing the terms of installment credit, without disturbing the basic framework of selective credit controls, Mr. Vasudevan noted. The authorities' intention to monitor continuously monetary developments and to have a full formal review early in the fourth quarter were welcome, particularly in view of the possible increase in the rate of inflation following devaluation and a relaxation in pricing policy.

The devaluation of the Trinidad and Tobago dollar in December 1985 had helped to reverse the real appreciation that had taken place since the late 1970s, Mr. Vasudevan observed. However, the authorities had simultaneously unveiled a dual exchange rate policy, with the lower rate, which had been in effect since 1976, continuing to be applied to essential imports. The authorities had maintained the dual rates principally in view of the uncertainties about the wage negotiations with public sector employees and about the oil price developments. He hoped that the dual rate system would be in operation on a temporary basis, and would be used mainly to bring about a better external financial position, which was vital for an economy with dwindling reserves and large development needs.

The authorities merited commendation for their wage restraint policy and their prudent external borrowing, Mr. Vasudevan stated. They had shown evidence of diversifying their economy and exports, and appeared ready to promote exports through financial assistance to exporters and encouragement for the establishment of joint ventures. Finally, he supported the proposed decision.

Mrs. Walker remarked that the authorities of Trinidad and Tobago had adopted important measures in key areas during the past several years to help the economy adjust to the real decline in oil prices. In 1985, those efforts had resulted in welcome improvements in the overall fiscal deficit, the balance of payments, the rate of inflation, and wage developments. However, real economic growth had declined and the performance of the non-oil economy had continued to sag, an even more significant development when oil prices had declined further than expected. To bring about internal and external financial balance and sustainable growth, in the light of the recent adverse developments in the oil sector, the authorities needed to take additional adjustment measures.

Further action in the fiscal sector would be necessary to accommodate the loss of revenue stemming from the recent collapse in oil prices, Mrs. Walker considered. On the basis of the 1986 budget and in the absence of corrective action, the consolidated public sector deficit would exceed 23 percent of GDP in 1986, and the current account would exceed 15 percent of GDP. The authorities were aware that failure to take corrective measures promptly would lead to even harsher adjustment measures later. Moreover, their track record on fiscal adjustment, which had included taking some difficult measures in the past two years on both the expenditure and wage fronts, gave her confidence that the authorities could take the needed additional measures.

To assist the fiscal adjustment effort, the authorities should consider adopting a system for monitoring expenditure that involved a broad-based review, Mrs. Walker stated. That system could be helpful for the weekly monitoring process.

Additional expenditure cuts would clearly need to be made, particularly in capital expenditure, Mrs. Walker went on. The staff had suggested cuts from the 1985 level amounting to 3 percent of GDP. The authorities, however, had stated that the size of the cuts would depend on assumptions for oil prices, on which there were differences between the staff and the authorities. Nevertheless, it was noteworthy that the authorities had stated that they would adjust expenditures to accommodate a lower oil price than US$18 a barrel.

While utility rates had been increased substantially during the past two years, the financial performance of the public utilities had remained weak, Mrs. Walker recalled. Central administration transfers to the public utilities had amounted to 11 percent of GDP in 1985, whereas total transfers to other public enterprises had been equivalent to about 7 percent of GDP. High operational costs, overstaffing, rising wages, low world market prices for some products, and the loss of competitiveness because of the exchange rate were reasons underlying the financial losses of the public enterprises. Given the drain that both the public utilities and other public enterprises had on the central administrative budget, she urged the authorities to consider measures to strengthen the savings performance of the public enterprises. While the authorities were understandably reluctant to make any further increases in utility rates, additional price adjustments would be needed to ensure that current revenues could at least cover operating costs. Further measures to improve the operations of other public enterprises were also needed, and she encouraged the authorities to consider the measures recommended by the staff.

The authorities should be commended for their cautious wage policy in recent years, Mrs. Walker said. She urged them to maintain a firm wage policy.

One of the striking facts during the past several years had been the decline in economic activity, Mrs. Walker indicated. Real GDP had fallen by more than 10 percent from 1983 to 1985, which had brought the drop in total output, from 1982 to 1985, to 17 percent. Most notable had been the decline in real growth in the non-oil sector. Real value added in the manufacturing sector--excluding petrochemicals and oil refining--had fallen by a cumulative 30 percent in 1984-85 as international competitiveness had eroded further. While the contribution of the agricultural sector to real GDP had increased to almost 4 percent in 1985, it was still low. There was a tremendous need to diversify the economy beyond the oil sector to bring about real economic growth that could be sustained. The staff had suggested the need for structural adjustment measures to reinforce the diversification of the economy and permit an early resumption of growth. The authorities should seriously consider the need for structural changes, particularly to develop the agricultural and manufacturing sectors. It would be helpful to have specific suggestions for structural adjustment measures from the staff. Measures to improve the climate and scope for foreign investment and a liberalization of import and exchange controls were needed to improve the prospects for growth.

The exchange rate policy would be a critical factor in promoting diversification of the economy, since a loss in competitiveness had adversely affected developments in the non-oil sector, Mrs. Walker observed. While she welcomed the devaluation of December 1985, she urged the authorities to unify the dual exchange rate system, which was particularly troublesome because it contributed to the fiscal problems through exchange subsidies. The flexible management of the exchange system, combined with cautious demand-management policies, should alleviate the need for exchange and import restrictions and result in better allocation of resources.

The authorities recognized that the economy of Trinidad and Tobago currently faced more difficult conditions than those facing the country during the recent adjustment efforts, and they were willing to take the necessary additional measures, Mrs. Walker concluded. She supported the proposed decision.

Mr. Salehkhou said that it was encouraging to note the remarkable improvement in 1985 in the public finances, the pursuit of a restrained monetary policy, and the maintenance of a cautious wage policy, which had resulted in a further decline in the overall fiscal and balance of payments deficits, and a deceleration in the rate of inflation under the adjustment program. However, the program had had an immediate, unfavorable impact on economic activity: GDP had continued to be negative and the unemployment rate had risen.

In Trinidad and Tobago, the oil sector dominated the economy and determined the size of government expenditures and domestic activities, Mr. Salehkhou indicated. The considerable increase in international oil prices in 1973-74 and in 1979-80, which had created a favorable environment conducive to growth and structural improvements, had led to a sizable expansion in government spending. With the weakening of the oil market, the authorities had recognized the need to undertake an adjustment program at an early stage to correct the domestic and external imbalances that had appeared in the economy in 1982. Since then, the implementation of a demand-management program through restrictive fiscal and monetary policies had helped the economy overcome most of the disequilibria.

In 1985, a sharp reduction in capital expenditures, the elimination of most subsidies on oil products, and an increase in the cost of some public utility rates had reduced the public sector deficit from 14 percent to 7 percent of GDP, Mr. Salehkhou continued. Given the lower demand for credit by the private sector, owing mainly to the recessionary trend in the economy and the further strengthening of the public sector finances, the expansion of net domestic assets of the financial system and broad money had been confined to 7 percent and 3 percent, respectively.

The implementation of demand-management policies, along with import rationalization, had led to a 19 percent decline in imports and had brought the external current account balance from a deficit of US$1.5 billion in 1984 to near balance in 1985, Mr. Salehkhou remarked. It was also encouraging to note the strong rise in nonpetroleum exports--primarily urea and methanol--at a time when petroleum exports were flat. Given the negative capital inflow, the overall balance of payments deficit had abated from about US$0.7 billion to US$240 million in 1985, and international reserves had remained unchanged, equivalent to nine months of 1985 imports. In 1985, the rate of inflation had been halved to 7 percent, resulting from the authorities' cautious wage policy and from lower government expenditures. Such substantial progress, while in line with the recommendations of the Executive Board during the previous Article IV consultation with Trinidad and Tobago (EBM/85/68, 5/1/85), had been achieved at the cost of further stagnation in the economy. Real GDP had continued to decline in 1985, and unemployment had risen to 15.3 percent.

The sharp fall in oil prices in 1986 had adversely affected the economy, and further corrective measures were needed to cope with the situation, Mr. Salehkhou considered. The authorities' intention to contain the consolidated public finance and external current account deficits was promising. However, further action was needed to adjust the economy and to bring the expected domestic and external accounts deficits down to sustainable levels. Any delay in implementing the necessary measures would require further austerity measures in the forthcoming years. For example, while the authorities' intention to confine the consolidated public sector deficit to 12.1 percent of GDP was a step in the right direction, that intention was not likely to be realized without reasonable expenditure cuts, given the limited room for expansion of the revenue base. Despite projections of a further

20 percent decline in imports, the external current account was expected to record a deficit of about 7 percent of GDP, and international reserves were projected to decline to six months of imports.

It was worth mentioning that the remarkable improvements obtained by Trinidad and Tobago from the successful implementation of three years of adjustment programs would be partially or totally offset by the adverse effect of the recent sharp fall in oil prices, Mr. Salehkhou stated. Nevertheless, given the uncertainties in the oil market, the authorities were not only forced to monitor and correct the policies envisaged for 1986, but also to start implementing measures to stimulate the economy so as to restore growth and alleviate the unemployment situation. He supported the proposed decision.

The staff representative from the Western Hemisphere Department, responding to a question about wage developments and their relation to the exchange rate, said that at the time of the consultation discussions, the staff had estimated that the appreciation of the Trinidad and Tobago dollar was still about 20 percent in real effective terms compared with 1978. The recent depreciation of the U.S. dollar, to which the Trinidad dollar was pegged, and the increasing occurrence of wage negotiations that resulted in nominal wages being kept constant or even reduced, indicated that the nominal devaluation could probably be somewhat lower. Although oil exports were not likely to respond to an exchange rate change and constituted a large proportion of the exports of Trinidad and Tobago, a devaluation would improve the competitiveness of the import substitution and nontraditional export sectors. Those sectors, excluding energy-related exports, had been significantly larger than at present.

In the first half of 1986, oil export prices had averaged US$17-18 a barrel, the staff representative continued. If oil prices remained at their present level for the remainder of 1986, the staff would still maintain the validity of the oil export price assumptions underlying the medium-term projections. However, it was difficult to assess the short-term fluctuations of oil prices, and the authorities would need to make further adjustments in public sector expenditures if the price of oil dropped below US$16 a barrel. The authorities had made a strong commitment to make such adjustments.

The World Bank currently intended to graduate Trinidad and Tobago, but the authorities were opposed to that intention, the staff representative explained. The devaluation of December 1985 had lowered the per capita income of Trinidad and Tobago, but it was still high compared with the cutoff point of the World Bank. Nevertheless, the authorities had indicated that they would insist on retaining their access to World Bank lending as well as to lending from the Inter-American Development Bank and other regional banks.

Noting Mr. Hospedales's statement that expenditure control was keeping the budget in near balance despite the fall in revenues, the staff representative said that the preliminary data received to date indicated that it was possible that the authorities would meet their fiscal targets for 1986. The role of the newly appointed commission of high-level officials was restricted to the monitoring of revenues and the authorization of corresponding expenditures, so as to enable Trinidad and Tobago to contain its deficit.

The staff was concerned about the potential for adverse effects from the lowering of the reserve requirement, the staff representative mentioned. Even if weak demand for credit did not result in an expansion of credit, the staff thought that the measure had sent wrong signals to the economy.

One important measure had been the improvement in relative prices through the adjustment of the exchange rate in December, but a further improvement in competitiveness would be helpful, especially to diversify the economy of Trinidad and Tobago, the staff representative from the Western Hemisphere Department stated. Other measures should include a change in the composition of public expenditure with higher investment in infrastructure, particularly in the agricultural sector, such as investment in storage facilities, drainage, and flood prevention. The liberalization of investment--foreign investment in particular--could also improve the structural conditions of the country and induce diversification. It was noteworthy that the Government was encouraging joint ventures with foreign investors. The country would also benefit from a reduction in regulations and administrative red tape.

Mr. Hospedales remarked that the secular decline in the price of oil over the past four years had made adjustment imperative, and the authorities had responded with a series of measures aimed at demand management, increased competitiveness, and structural improvements. Given the need for a sustained adjustment effort over the medium term, the authorities had put into place the appropriate machinery to align aggregate demand with the availability of resources, so as to achieve a significant reduction in the fiscal deficit and to consolidate the significant gains won in the initial phase of the adjustment. As a precautionary measure, expenditures had been programmed at a level that would not exceed the estimated revenue cash flow and the available domestic financing. Data for the first six months of 1986 had shown that the program was on track. The flexible mechanism, subject to continuous review, would respond effectively to any change in the material circumstances of Trinidad and Tobago so as to avoid any increase in net external borrowing on a scale inconsistent with the debt servicing capacity of the country.

Apart from wages and salaries, which were being determined within a legal framework, the authorities were seeking to realize the bulk of savings in government purchases of goods and services, transfers to the public enterprises and utilities, and capital expenditure, Mr. Hospedales continued. The authorities were committed to a national pay restraint program, and in their negotiations with the public sector employees, were seeking a five-year agreement in which the Government would offer a 6 percent increase. If the special tribunal accepted the Government's proposal, a significant reduction in real wages over the medium term would result.

The authorities considered that influencing the wage settlement process in the context of a general industrial relations strategy, which emphasized the importance of the competitiveness of the country's wage behavior, could enhance wage responsiveness to the macroeconomic conditions, Mr. Hospedales added. In that connection, private sector pay had been showing increasing signs of moderation. Of course, other significant savings had been effected on the external debt service payments and on capital expenditure, which had been reduced, but every effort was being made to retain a certain level of capital expenditure to ensure that future growth was not impaired.

The strengthening of the operations of public enterprises and utilities had reduced--and in some cases, eliminated--their dependence on transfers, Mr. Hospedales went on. Substantial increases had occurred in tariffs on telephones, electricity, water, sewage, transportation, and in port charges.

The recent relaxation in monetary policy had come at a time of general concerns about the protracted stagnation of the economy, Mr. Hospedales commented. The rising unemployment, the absence of signs of recovery in the economy, and the squeeze on the private sector's access to credit under the prevailing restrictive conditions had led the authorities to relax some terms of credit in the expectation that the more productive sectors would benefit from the lowering of the cost of funds. The authorities' expectations were in fact being realized at present; nonetheless, they were taking care to review the measures continuously to ensure that excess demand conditions did not emerge and impair the success of the exchange rate policy or the sustainability of the balance of payments.

In their efforts to support private investment, the authorities had been preparing a revised foreign investment code, and had established a new unit in the Ministry of Finance and Planning to resolve systemic problems in their approach to foreign investors, Mr. Hospedales reported. The authorities considered, in the light of increasingly difficult access to external borrowing, that a resumption of flows from the multilateral development institutions was important at that stage of their development process.

The authorities held the view that the large exchange adjustment of December 1985 had contributed significantly to the competitiveness of the economy, and that the real effective exchange rate was currently in a range that was satisfactory, credible, and broadly appropriate, Mr. Hospedales indicated. They saw limited scope for a more active exchange rate policy, because they were convinced that any departure from an established policy of stable pegging could have the unwanted effect of undermining confidence in the country, which could have repercussions in terms of capital flight. The authorities thought it best to stabilize the overall economic framework at present so that the economy could accommodate the large adjustments that had been taking place over the past few months. While the authorities regarded the dual exchange market as a temporary mechanism, they saw its conversion as a gradual evolutionary process. It was noteworthy that the dual exchange market had done well in facilitating the reorientation of wage and inflationary expectations to the current economic reality and to the outlook for the economy. Over the long term, the authorities considered the strengthening of the current account balance through an aggressive export thrust and diversification to be the key to improving economic performance in Trinidad and Tobago.

The influence of the petrochemical sector had caused the energy contribution to GDP, as well as its percentage of exports, to rise, Mr. Hospedales noted. That performance, when added to the potential of other nontraditional activities and the pursuit of financial discipline, would go a long way toward establishing the conditions for resumption of growth in the country.

The Chairman made the following summing up:

Executive Directors were in broad agreement with the thrust of the staff appraisal in the report for the 1986 Article IV consultation with Trinidad and Tobago.

Directors commended the authorities for the progress made in 1984-85 in coping with the effects of the decline in oil export earnings, particularly through the reduction of the fiscal deficit. They noted, however, that that had been achieved to a significant extent through a cutback in capital outlays; other contributing elements were an increase in public utility tariffs and the elimination of most of the subsidies on oil products. As a result of the reduction in the fiscal imbalance and the tightening of import and exchange controls, the external current account deficit had been virtually eliminated and the overall balance of payments deficit had been reduced substantially in 1985. Directors noted the significant easing of inflationary pressures that had taken place in 1985, while economic activity had continued to slacken and unemployment had increased.

Directors commented that the recent decline in international oil prices had weakened substantially Trinidad and Tobago's economic prospects, as petroleum export earnings were expected to fall by more than 10 percent of GDP in 1986. In that context, Directors stressed the need for an intensification of adjustment measures to avoid a severe external payments problem and pickup of inflation.

Accordingly, Directors urged the authorities to continue with their effort to implement expenditure cutbacks within a medium-term plan for reducing the imbalances in the public finances and to monitor closely public expenditures. Directors noted that even if the fiscal target set by the authorities for 1986 were achieved, Trinidad and Tobago's net international reserves would experience a substantial decline.

Directors therefore stressed that further adjustment in the public finances would be needed in 1987 and beyond to attain a sustainable external position and price stability over the medium term, and thus to create the conditions for the resumption of economic growth. Directors were of the view that the public enterprises and utilities--which still attracted public transfers in the order of 10 percent of GDP--should contribute to the fiscal adjustment through further price and tariff adjustments, together with other measures to raise their operational efficiency and to make them viable and self-sufficient.

Concern was expressed about the recent relaxation of monetary policy through the reduction of reserve requirements because it could lead to additional balance of payments and inflationary pressures. Directors noted the importance of strengthening savings, and in that connection, pointed to the desirability of allowing deposit interest rates to rise.

Directors observed that the slowdown in wage increases in recent years had played an important role in the adjustment process. In the light of the latest pronounced decline in external income, Directors emphasized the need for continued wage restraint to prevent unemployment from becoming an even more serious problem.

Directors noted the importance of moving to a unified exchange rate as soon as possible, because the present dual exchange rate system was adding to the fiscal imbalance through the exchange subsidies it involved and was leading to distortions in the allocation of resources. Directors welcomed the devaluation of the Trinidad and Tobago dollar at the end of 1985. They were of the view that a continuing monitoring of international competitiveness and flexible management of the exchange rate were needed, particularly in the light of the recent large loss in external earnings, in order to avoid excessive reliance on demand-restraint policies while inducing changes in the pattern of expenditure and encouraging the diversification process in the non-oil sector of the economy. An improvement in competitiveness in conjunction with cautious demand-management policies would facilitate the progressive removal of import and exchange restrictions.

Although the external debt service ratio was projected to remain relatively low, Directors agreed with the authorities on the desirability of improving the maturity profile of the public external debt by increasing borrowing, especially for structural reforms, from regional and multilateral organizations.

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

The Executive Board took the following decision:

1. The Fund takes this decision relating to exchange measures of Trinidad and Tobago subject to Article VIII, Sections 2 and 3, and in concluding the 1986 Article XIV consultation with Trinidad and Tobago, in the light of the 1986 Article IV consultation with Trinidad and Tobago conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Trinidad and Tobago has maintained a foreign exchange allocation system for imports and intensified other exchange restrictions since 1983 and has maintained a multiple currency practice resulting from the dual exchange rate system since December 1985. The Fund urges Trinidad and Tobago to implement policies which will facilitate the prompt removal of these practices.

Decision No. 8350-(86/123), adopted
July 28, 1986

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/86/122 (7/25/86) and EBM/86/123 (7/28/86).

2. ZAMBIA - OVERDUE FINANCIAL OBLIGATIONS - REPORT AND COMPLAINT UNDER RULE K-1

1. The complaint of the Managing Director dated July 18, 1986 on Zambia in EBS/86/156 (7/18/86), is noted. It shall be placed on the agenda of the Executive Board for August 25, 1986.

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

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

Decision No. 8351-(86/123), adopted
July 25, 1986

APPROVED: April 14, 1987

JOSEPH W. LANG, JR.
Acting Secretary