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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/171

10:00 a.m., October 17, 1986

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	Mawakani Samba
C. H. Dallara	M. K. Bush
	E. L. Walker, Temporary
	G. Seyler, Temporary
M. Finaish	T. Alhaimus
H. Fujino	M. Sugita
G. Grosche	
	Jiang H.
J. E. Ismael	
A. Kafka	H. A. Arias
	J. Hospedales, Temporary
	M. Foot
	S. King, Temporary
H. Lundstrom	
	L. Leonard
	A. Abdallah
F. L. Nebbia	
	J. E. Suraisry
	J. E. Rodríguez, Temporary
H. Ploix	S. de Forges
J. J. Polak	A. V. Romuáldez
C. R. Rye	O. Kabbaj
	R. Msadek, Temporary
A. K. Sengupta	A. S. Jayawardena
S. Zecchini	N. Kyriazidis

L. Van Houtven, Secretary
S. L. Yeager, Assistant

Also Present

IBRD: D. Elvis, Latin America and the Caribbean Regional Office. European Department: B. Rose, Deputy Director; H. Vittas. Exchange and Trade Relations Department: C. D. Finch, Counsellor and Director; M. Guitián, Deputy Director; J. T. Boorman, S. Kanesa-Thasan. Legal Department: J. K. Oh. Middle Eastern Department: A. S. Shaalan, Director; P. Chabrier, Deputy Director; M. A. El-Erian, P. S. Griffith, D. Hammann, S. H. Hitti, Z. Iqbal, B. A. Karamali, M. F. Melhem, K. Nashashibi, D. B. Noursi, B. K. Short, M. Yaqub. Research Department: R. R. Rhomberg, Deputy Director. Western Hemisphere Department: E. Wiesner, Director; J.-P. Amselle, E. L. Archer, M. Caiola, M. A. Da Costa, J. Ferrán, A. C. A. R. Furtado, M. E. Hardy, J. P. Pujol, J. E. Sundgren, M. A. Tareen, K. Thugge, G. Yadav. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: A. Bertuch-Samuels, M. B. Chatah, S. M. Hassan, A. Ouanes, G. Pineau, I. Puro, A. Vasudevan. Assistants to Executive Directors: O. S.-M. Bethel, J. de la Herrán, F. Di Mauro, J. J. Dreizzen, W. N. Engert, G. Ercel, R. Fox, V. Govindarajan, L. Hubloue, O. Isleifsson, T. Morita, J. A. K. Munthali, A. H. Mustafa, G. Schurr, S. Simonsen, B. Tamami, H. van der Burg, Wang X., B. D. White.

1. MEXICO - REPORT BY DEPUTY MANAGING DIRECTOR

The Deputy Managing Director reported that the previous evening telexes had been sent to the commercial banking community presenting the term sheet and related documents associated with the agreement between the commercial banks and the Mexican authorities on a financial package for Mexico. Also included was a telex from the Managing Director, which gave a brief description of the economic program and indicated that before the stand-by arrangement for Mexico could be approved, adequate financing for the program would have to be assured. The Managing Director had also indicated that he would like to receive such assurances from the commercial banks by October 31. The communications were similar to those sent by the Managing Director on previous occasions when the Fund had helped to catalyze external financing for a member country's adjustment program.

The stand-by arrangement for Mexico would be scheduled for Board discussion on October 31, the Deputy Managing Director added. Directors would be receiving a staff report providing up-to-date details on the discussions between the Mexican authorities and the commercial banks, the World Bank, and the Fund staff on external financial arrangements for Mexico early in the coming week. Completion of that paper had been delayed because some of the final terms of the agreement between commercial banks and the Mexican authorities had been reached only the previous day.

2. DOMINICA - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with Dominica (SM/86/242, 9/15/86). They also had before them a background paper on recent economic developments in Dominica (SM/86/247, 9/29/86).

Mr. Leonard made the following statement:

> My authorities would like to express their appreciation to the staff for a well-prepared and accurate report, the basic substance of which they endorse, and for the courtesy and frankness that characterized the consultations.
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> The performance of the economy of Dominica since the last Executive Board discussion in July 1985 (EBM/85/107, 7/15/85) evidences the continued determination of the authorities to pursue appropriate and effective policies for growth and adjustment. While real GDP increased by only about 1 percent in 1985, largely owing to near completion of the road improvement program and the effects of poor weather on agricultural crops, it is expected to rise by about 4 percent this year. At the same time, the rate of inflation is being contained to a range of 2 percent to 2 1/2 percent, the external deficit on current account is averaging about 5 1/2 percent of GDP, and the overall balance is positive but to a lesser extent than in 1984 when it amounted to 6 1/2 percent of

GDP. Unfortunately, unemployment remains high at somewhere between 15 percent and 20 percent of the labor force according to official estimates.

Since membership of the Eastern Caribbean Central Bank (ECCB) closely confines the scope of monetary policy, the main burden of economic management falls on fiscal policy and supply-side measures. Through the use of these instruments the authorities are seeking to establish a solid base for future growth and higher living standards. At present, investment expenditure is for the most part financed from external sources in the form of grants and concessionary loans. It is vital that these should continue for some years to come, but the authorities accept the need to supplement such finance by domestic saving and their management of the economy is shaped accordingly.

Current expenditure of the Central Government has been reduced from 33.6 percent of GDP in fiscal year (FY) 1982 to 30.5 percent of GDP in FY 1986, and a further marginal fall is projected for the current year. Government savings are running at an average annual rate of 1 percent to 1 1/2 percent of GDP, and among the public enterprises as a group, savings are also being generated instead of the negative balances which marked their operations in previous years. These trends are reflected in the consolidated accounts of the public sector overall where increasing savings have been recorded since FY 1984 and were the equivalent of over 4 percent of GDP in FY 1986. In the same year a small positive overall balance was achieved.

The authorities intend to maintain the improving trend in the public finances through the further limitation of wages, reforms in labor law, and rationalization of the civil service. Consolidation and better management of various public enterprises have also been effected, with divestment of one agency in the process; further structural changes are under examination. Measures to increase revenue will concentrate on the tax system, with modifications being made to allow for incentives for production in certain sectors including manufacturing. Increased tariffs to cover the improved services of the public enterprises will be put in place where justified and circumstances allow.

The scope for monetary policy is limited. It is expected, however, that with continued public sector saving, and continued financing of the bulk of public investment by external sources, the liquidity of the banking system should be such as to allow adequate domestic financing of private sector investment. Higher interest rates on deposits are expected to encourage private saving and further enlarge the possibilities of domestic credit expansion.

As noted by the staff, the real effective exchange rate of Dominica's currency has declined markedly since early 1985 with the fall in the U.S. dollar. To the extent that the present rate bears on competitiveness, its adverse effects are being mitigated by fiscal action. Direct action on the exchange rate itself is scarcely practical because of differences in the impact of changes in the rate on the economies of the members of the ECCB and consequent difficulties in securing agreement on what change would be appropriate.

Dominica's resource base is narrow. Its exploitation and enlargement will continue to depend for the most part on the initiative of the private sector. The authorities, however, stand ready to encourage that initiative as far as possible and to be flexible in the choice of methods of doing so. At the same time, they recognize that in certain instances private enterprise may fail to exploit economic opportunities that are commercially viable. In such instances, they believe that state enterprise may be called for initially with the way being left open for divestiture of the project concerned at an appropriate time.

Investment in infrastructure has been the most prominent feature of development expenditure so far, but other measures as described in the staff papers have also been put in train and are giving useful results. The authorities look to the availability in the years ahead of further grants and concessionary finance for the improvement of the island's infrastructure. They also look to fruitful collaboration with the Fund and the World Bank in the balanced management of the economy and in the encouragement of productive investment.

The staff's medium-term projections suggest that growth of the order of 3 1/2 percent to 4 percent is possible in 1986-90, subject to further strengthening of the public finances, general prudence in economic management, and intensification of efforts to promote exports and tourism. The external deficit on current account should narrow and remain manageable; the overall balance should be modestly positive and allow Dominica to combine small increases in external reserves with full service of its debt obligations to the Fund and others.

It is the intention of the authorities to ensure that the general evolution of the economy will be on the lines projected and their past performance gives every reason for confidence that their intentions will be realized.

Mr. Hospedales made the following statement:

Over the past five years Dominica has been implementing far-reaching adjustment and structural measures to correct severe internal and external imbalances, which had been aggravated by the 1979-80 hurricanes and more recently by the 1984 heavy rainstorms. Two Fund-supported programs had facilitated the process of adjustment, which had been difficult and painful; however, notwithstanding the interruption of financing under the 1984-85 stand-by arrangement, Dominica's continuing commitment to adjustment and sound economic management are laying the foundation and creating the conditions for higher self-sustaining growth rates and employment levels as well as a sustainable and viable balance of payments position. We are in general agreement with the thrust of the staff report, which details the considerable progress made by Dominica. Mr. Leonard has also provided excellent insights into the peculiar and particular circumstances associated with small island economies.

Dominica has come a long way in restructuring and rehabilitating its economy consequent to the severe external shocks to that economy; the infrastructure is returning to a viable condition, the current deficit of the balance of payments has declined substantially, the overall accounts of the Central Government are in approximate balance, and the rate of inflation has decelerated markedly. However, the sustained structural adjustment of the economy has not been without considerable sacrifice--real GDP growth has slackened to 1.1 percent in 1985, reflecting the impact of a major retrenchment in government capital expenditure, and unemployment remains in a range of 15 percent to 20 percent. For this reason, and to ensure that growth and per capita incomes and living standards are strengthened, we concur with the authorities' decision to initiate action to accelerate real economic growth over the medium term; their intention to reconcile this process within a framework of fiscal and balance of payments discipline is well conceived. The authorities recognize clearly that the resilience of the balance of payments to external shocks such as those frequently experienced by Dominica can be assured only through a more diversified productive base and expansion of nontraditional exports. Dominica's continued need for external financial assistance to facilitate this growth-oriented process therefore merits due consideration, especially in the light of the unavoidable decline of government capital expenditure by approximately 3 percentage points of GDP in the current fiscal year. In the circumstances, the authorities' commitment to enhance capital expenditure over the next two years to ensure that future growth is not unduly impaired is well placed.

The continuing involvement of the World Bank in Dominica is welcome, and the Bank's early approval of the cofinancing arrangements for the hydroelectric project and the US$3 million structural adjustment credit are important elements in ensuring that the share of investment in GDP be improved, thereby restoring sound and sustainable growth rates. In this connection, Dominica's request for the World Bank and the Fund to evaluate the economic and financial viability of additional investment projects, including the water export project, should be given priority consideration. On this general question of structural change and adjustment, we would hope that evolving elements of cross-conditionality should not unduly delay the conclusion of a structural adjustment arrangement with the Fund or disbursements under the World Bank structural adjustment credit.

In the context of Dominica's commitment to annual average capital expenditure of about 25 percent of GDP over the next two years, the authorities have correctly decided in their current budget to strengthen efforts to mobilize public sector resources through a comprehensive and effective fiscal strategy encompassing a wide number of areas, including the adoption of additional revenue-raising measures, a continuation of the program to improve the financial performance of public enterprises through technical and managerial improvements and further adjustments in prices, enhanced tax administration and collection efforts, and a program of expenditure rationalization and restraint. We are certain that as a result of these vigorous demand management and structural policies, the financial balances of the public sector will be further improved in the current fiscal year, thereby accommodating investment and growth in the private sector.

It is encouraging to note that this process of adjustment is being further consolidated over the medium term in the context of administrative reorganization of the public service and a major tax reform exercise. The authorities will be well advised, however, to adopt a wage and employment policy for the public sector consistent with the need to maintain a lasting improvement in public finances. For Dominica, price and cost restraint to maintain international competitiveness is of the essence if the objective of accelerated growth is to be achieved through the long-term expansion of investment and exports, in view of the authorities' efforts to restore those conditions of confidence and stability associated with their fixed exchange rate objective.

Mr. King made the following statement:

The authorities have made further progress in the past year in their efforts to improve the outlook for the economy over the medium term by strengthening the fiscal and balance of payments positions and building up the level of reserves. The constraints upon monetary and exchange rate policies resulting from Dominica's membership of the Eastern Caribbean Central Bank inevitably mean that the main burden of achieving this objective must fall on fiscal and structural policies. Accordingly, the authorities have made further significant progress in strengthening the fiscal position over the past year: the overall fiscal deficit showed a small surplus compared with the deficit of over 11 percent of GDP only four years previously. This improvement has helped support a similarly marked improvement in the current account deficit.

Judging from the staff report and Mr. Leonard's statement, the authorities are well aware of the need to continue improving fiscal policies over the next few years if the improvement in the external position is to be maintained and if the debt service burden is not to become excessive. The rise in the debt burden to 50 percent of GDP, while not perhaps a source for immediate concern, suggests that the authorities should only undertake additional nonconcessional borrowing with some caution and for projects that seem assured to generate sufficient returns to be self-financing. The advice of the World Bank in determining which projects fit this criteria will, of course, be important.

The fall in the exchange value of the U.S. dollar over the past 18 months has led to a significant reduction in the effective real exchange rate of the East Caribbean dollar, which nonetheless remains substantially above its 1981 level. Furthermore, Table 7 of the staff report seems to suggest that Dominica's competitiveness over the period since 1981 has deteriorated more than that of all other members of the ECCB, except one. This decline in competitiveness may partly explain the relatively sluggish performance of private investment in Dominica. It also underlines the importance of continuing to review exchange rate developments periodically with other members of the ECCB.

The limitations on exchange rate policy at present also mean that it is essential to keep wage settlements under tight control. In that regard, control over public sector wages is most important. Public sector wages not only constitute a major component of public expenditure, they also have a significant role to play in influencing wage settlements throughout the economy. Real wages in the public sector have risen strongly in recent years, and it is therefore encouraging to see that the authorities have decided to suspend the granting of automatic merit increases as a way of curbing the wage bill during the current wage agreement. It would also seem to be appropriate that wage increases after the current agreement expires in mid-1988 should be examined carefully to ensure that they do not adversely affect competitiveness.

The authorities are also considering the possibility of a tax reform package. While tax reform would generally have a potentially valuable role to play in improving incentives, the need to continue to protect and, where necessary, to strengthen the fiscal position suggests that any revenue loss incurred as a result of a tax reform package should be offset by measures either on the expenditure side or on the revenue side.

In sum, the authorities' continued efforts to strengthen the medium-term outlook for the economy is commendable. The improvement in the fiscal position over the past few years has played an important role in this regard. I hope that the authorities are able to maintain, and where necessary strengthen, the fiscal effort and that the Board will have an opportunity in the near future to discuss an arrangement for Dominica under the structural adjustment facility. In the light of the policy constraints on the authorities, a program in support of an arrangement will presumably concentrate on fiscal and structural policies.

Mrs. Walker made the following statement:

Recent developments in Dominica, particularly in the fiscal sector, have been generally positive. Although real GDP growth declined from 6.2 percent in 1984 to 1.1 percent in 1985, growth in certain areas--such as manufacturing--expanded considerably, and progress was made in other areas. Most notably, the rate of increase in consumer prices declined further in 1984-85 to an average of 2 percent, and surpluses were achieved in the overall balance of the consolidated public sector, the overall balance of the public enterprises, and the balance of payments. Furthermore, the authorities are committed to continue adopting policies conducive to adjustment while maintaining economic growth. Their overall strategy, involving fiscal and supply-side measures as well as an expanding role for the private sector, has been appropriate in the circumstances.

According to the staff, the medium-term outlook--with real growth projected to increase at a rate of 3 1/2 percent to 4 percent a year between 1986 and 1990--is positive. We believe such rates of growth can be achieved if the authorities continue to pursue policies aimed at developing the economy through private sector activities, while the public sector focuses on providing an environment favorable to private sector growth.

Because of the constraints faced in other policy areas, the authorities have concentrated their efforts on improving domestic saving, particularly by increasing public sector saving. Those efforts should be continued. The budget for fiscal year 1986/87 should produce a further narrowing of the overall deficit of the Central Government. However, the budget does not include spending for a new water export project presently under consideration, which is in line with the staff recommendation not to contract debt not covered in the Public Sector Investment Program (PSIP) to finance this project. Furthermore, there is a continued need to avoid any government borrowing on nonconcessionary terms, from domestic or external sources, to finance projects not included in the PSIP.

We welcome some of the recent changes in the tax laws, including reductions on the foreign exchange levy and company profits tax as well as the removal of taxes on exports and bank deposits. We are also pleased to hear from Mr. Leonard that the tax package involves modifications to allow for incentives to increase production in manufacturing and, therefore, exports. We would encourage the authorities to aim at removing any disincentives to production during their review of the entire tax system. In light of the need for fiscal discipline, however, any tax reform should be revenue neutral.

Wage expenditures have been high in the past. However, we welcome the authorities' efforts to control the wage bill by not granting automatic merit increases and their intention to introduce new wage legislation to improve the wage bargaining environment and provide a uniform wage policy in the public sector. We will be interested to hear the results of a management study on rationalization of the civil service; will the World Bank be involved in this area? Clearly, in light of the limitation on the use of exchange rate policy, a prudent wage policy will be important to improve Dominica's international competitiveness.

The public enterprises have been reducing their indebtedness to local commercial banks and have made net transfers to the Central Government in the last three fiscal years. According to the staff report, the authorities expect to strengthen this favorable trend in the future by adopting additional measures, which include a sizable increase in port user charges, a reorganization of a major public enterprise, and wage legislation. Efforts to continue to improve the financial position of the public enterprises through tariff increases, where appropriate, and other measures are important and should be continued.

The authorities are looking to the private sector as a major contributor to growth of the economy's resource base; that approach is a good one. However, it is worrisome that the authorities believe that, in those areas where private enterprise may not become involved in commercially viable opportunities, the Government should set up public enterprises that could be divested at a later date. While the authorities have managed to divest public enterprises in the past, it is clearly more difficult to privatize a company than it is to create one. The commercial viability of a project may also be questionable, if the private sector is not interested in it; however, in that regard, we recognize that the private sector is small in Dominica. Most important, it is difficult to envisage how the Government's efforts at fiscal constraint could be maintained if more public enterprises were created. I would appreciate comment from the staff or Mr. Leonard on this point.

We welcome the authorities' efforts to provide support for the private sector by making more credit available to it and by encouraging foreign and domestic investment in the manufacturing sector through the Industrial Development Corporation--which will include the Tourist Board in the future--and through the Agricultural Industrial and Development Bank. In addition, the Dominica Import and Export Agency is expected to help agricultural exports, which have faltered in recent years. The Government has accelerated its citrus rehabilitation program, and the new export agency should help assist this industry in securing new export markets. Furthermore, I understand that the authorities are exploring the possibility of establishing an export processing zone; I wonder if the staff can elaborate on that matter.

The possibility of an arrangement for Dominica under the structural adjustment facility raises questions relating to the assessment of a balance of payments need. In determining the existence of a balance of payments need, the Fund gives the benefit of the doubt to a member, and we would not question Dominica's general balance of payments need. However, we wonder whether the technical requirement of a protracted balance of payments problem, as called for in the Regulations for the use of the resources accruing to the Special Disbursement Account, is met in this instance. Although the Board's decision does not specify exactly what was meant by "a protracted balance of payments need," it had been suggested that the staff's assessment of such need would include past, present, and future balance of payments developments and that various external indicators can reflect a protracted payments need. The table on Dominica's balance of payments in SM/86/242 shows that while there is a current account deficit of at least 5.3 percent of GDP in 1986 and that the deficit will increase slightly in 1987 and 1988, the performance of the capital account results in a small overall balance of payments surplus in the same period. We would appreciate staff comment on the existence of a protracted balance of payments need in these circumstances; also, what would be the implications of providing assistance under the facility to a country that may not have a clear protracted balance of payments need for other requests under that facility?

Our concern regarding the technical requirement of a protracted balance of payments need should not be interpreted as raising questions on the appropriateness of the thrust of the authorities' policies in recent years--which we commend--nor their efforts in the future. We encourage the authorities to continue their efforts, and we will look for ways that the international community can support them.

Mr. Polak made the following statement:

The Dominica economy has generally been well managed in recent years. Growth is likely to return to a satisfactory level this year, the inflation rate is admirably low, and the external position is sustainable, given the relatively high level of external assistance.

Dominica is confronted with the usual problems facing small island economies, such as considerable dependence on external factors and limited diversification. There is little that the authorities can do about external dependence, although membership of the Eastern Caribbean Central Bank and CARICOM ought to be helpful in this respect. The narrowness of the resource base is also an important constraining factor. All possible avenues of productive investment should, however, be examined; I therefore welcome the authorities' intention to have the World Bank evaluate investment projects not included in the PSIP. I also note in this context the relatively modest contribution of tourism to the economy.

In the recent past, important progress has been made in Dominica's public finances. The overall central government deficit is continuing to narrow from previously high levels and is expected to be equivalent to no more than 0.4 percent of GDP in fiscal year 1986/87. It will be crucial to keep up the efforts that have been made in this area. As the staff points out, fiscal developments are closely tied to Dominica's medium-term economic objectives. Government capital outlays are expected to be covered by external assistance. In that regard, could the staff indicate to what extent Dominica could benefit from the Caribbean Basin Initiative?

Wages remain an area of vulnerability. Whereas wage increases have moderated in recent years, they remain high in relation to both price increases and productivity. Wage moderation in the public sector and efforts to streamline the civil service are highly desirable.

The medium-term outlook is quite favorable under the crucial assumption of prudent fiscal management and moderate wage developments. The reduction of the external current account deficit to around 4 percent of GDP by 1991--given expected capital inflows--places Dominica in a comfortable foreign exchange position, which would enable it to meet its debt servicing obligations--including those to the Fund--without difficulty. As Mrs. Walker has pointed out, Dominica is likely to have an overall surplus on its current account, an achievement for which, in our view, it should not be punished.

Dominica has initiated discussions on a program to be supported by an arrangement under the structural adjustment facility. While the country's per capita income is higher than the IDA ceiling that was originally applied in determining access to that facility, it still qualifies for access because of the subsequent addition of a number of small island economies to the list of eligible countries. In view of the need for further structural changes in the economy, I can in principle support Dominica's use of resources under the structural adjustment facility.

Mr. Rye made the following statement:

I agree with the staff report and note with satisfaction the impressive economic achievements of the Dominica authorities over the past year and a half. In particular, the fiscal consolidation represents a substantial achievement and deserves our commendation.

I intervene mainly to raise two questions. First, on investment policy, Mr. Leonard has indicated that the authorities believe that in some cases private enterprise may fail to exploit commercially viable economic opportunities, and that in such instances, state enterprises may be called for initially with the way being left open for divestiture of the project concerned at an appropriate time. Although markets are frequently imperfect, state intervention as suggested carries obvious dangers. It smacks of "picking winners"--something at which the most sophisticated governments have proved inept. One possibility is that the Government may find itself locked into projects which in the end turn out to be economically unviable after all. The possibility of costly mistakes is clearly to be guarded against. An alternative approach might be to seek to remove those impediments to the efficient operation of the market which cause these opportunities to be neglected in the first place. Perhaps, for example, more publicity is needed. I would be interested to hear any elaboration Mr. Leonard may care to give on this point.

The second question concerns the Eastern Caribbean Central Bank. It is somewhat surprising that this institution is taken as totally "given" in the staff report. There are obvious merits in such an institution providing common monetary services for a group of similar small economies located in the same general area. But there are costs as well--as is brought out clearly in the staff papers, particularly in Appendix B to the background paper on recent economic developments.

I note the wide range of differences in movements in the real effective exchange rate in member countries, and that in every case there has been a real effective appreciation since 1980. However, the possibility of a change in the value of the Eastern Caribbean dollar is quite remote, since it requires the unanimous recommendation of the Monetary Board of Directors followed by unanimous decision of the Monetary Council. To an outsider, these procedures seem excessively rigid, and indeed no change in the currency value has ever been brought about. I therefore wonder whether there are any plans for a review of the ECCB, and in particular, of its decision-making processes. I would also be interested to know whether any study of the costs and benefits of this institution to member countries has been conducted and whether member governments are fully satisfied that it meets their needs.

Finally, I have to take issue with Mrs. Walker about the existence of a protracted balance of payments need. It is true that a capital account surplus has covered the current account deficit in recent years, but only by virtue of public sector borrowing. That fact seems sufficient to establish the existence of a balance of payments need, and I am certain that we should not take too legalistic an approach to this matter.

The staff representative from the Western Hemisphere Department remarked that the staff was optimistic that discussions with the authorities on an economic program that could be supported by an arrangement under the structural adjustment facility would be concluded in the near future, and that the program would enable the authorities to continue implementing the prudent policies they had been pursuing. In particular, the program would aim at achieving sustainable growth while strengthening the fiscal and balance of payments positions; strengthening Dominica's ability to service its external debt; and building up a cushion of reserves against external shocks. In that context, the staff was mindful of the need to avoid cross-conditionality with the World Bank with respect to disbursements of structural adjustment credits to Dominica.

The balance of payments scenario had been designed to create the surplus needed to service Dominica's obligations to the Fund, the staff representative continued. The current account balance, which was determined largely by the public sector investment program, was financed either by official transfers or by concessionary loans related to investment projects. That financing itself established a balance of payments need for Dominica to the extent that public sector investment was needed to strengthen the country's export and tourism receipts.

For some time the authorities had been receiving technical assistance from the interagency resident mission for a study on the rationalization of the civil service, the staff representative commented. Unfortunately, the study had been delayed because of administrative difficulties. Those difficulties had been resolved, and the authorities expected that a preliminary draft of the study would be completed by the spring of 1987. The authorities also expected to take some action on the basis of that study by mid-1987. He understood that the World Bank was not involved in the study.

The authorities' objective in seeking to establish an export processing zone was not only to promote exports but also to complement the fiscal incentives for export activities, the staff representative explained. The authorities considered that establishment of an export processing zone would enable them to monitor the use of materials imported under the Fiscal Incentives Act. Some donors were considering the project, although there was not yet strong donor support for an export zone.

The Caribbean Basin Initiative had had little impact on investment in Dominica thus far, although discussions had been held with potential investors, the staff representative noted. The authorities expected that the Initiative would have some impact in the future, in particular by assisting them in exporting certain processed agricultural products, for example, by participation of U.S. importers in the processing activity. Under the Initiative some garment-producing industries had been established in Dominica. However, two garment industries which exported within the region had closed down because of the difficulties they faced in the region.

As to the flexibility of the ECCB's decision-making processes, it should be noted that the ECCB had replaced the East Caribbean Currency Authority, which did not even have the power to regulate the exchange rate, the staff representative observed. The ECCB had, however, been empowered to devalue or revalue the currency through an established voting procedure. Thus, the decision-making process of the monetary authority had been somewhat improved.

The staff shared the concerns expressed by many Directors regarding Dominica's investment policy, the staff representative from the Western Hemisphere Department remarked. The staff had encouraged the authorities to avoid involving the public sector directly in productive activities. In that regard, the staff had taken a cautious approach in its negotiations with the authorities on a program to be supported by an arrangement under the structural adjustment facility.

The staff representative from the Exchange and Trade Relations Department remarked that when the Executive Board discussed the establishment of the structural adjustment facility, Directors had generally agreed that the requirement of a protracted balance of payments need would not be determined according to specific criteria but would rather be determined on a case-by-case basis in light of individual circumstances and that the benefit of the doubt would be given to the member in assessing its situation. There was also a general understanding that a member having an improved balance of payments position as a result of the implementation of good adjustment policies should not be penalized by denying it access to the structural adjustment facility. It should also be noted that the balance of payments projections for Dominica were based on assumptions that might not materialize. For example, exports were projected to grow at an annual rate of 14 percent; however, the country depended heavily on exports of primary products, which were subject to sharp price fluctuations. Thus, considerable uncertainty surrounded those projections. The current account balance was likewise heavily dependent on official transfers; the outcome of the PSIP also influenced the assumptions underlying the balance of payments. Thus, the projected overall balance of payments surplus should not be a basis for deciding whether Dominica had a prolonged balance of payments need. In sum, the requirement of a protracted balance of payments need had to be applied in a flexible and country-specific manner, which gave the benefit of the doubt to the member.

Mrs. Walker said that she appreciated the staff's response. She wished to make it clear that her intervention had been intended to prompt an examination of the question of protracted balance of payments, which for Dominica was not clear from reading the report. In that regard, whether a protracted balance of payments problem existed should be determined in a flexible manner on a case-by-case basis.

Mr. Leonard remarked that the staff representative from the Exchange and Trade Relations Department had been particularly perceptive in describing the situation in Dominica and the way that the structural adjustment facility should be utilized. It would be very easy for a country to establish a balance of payments need so that various people would rush to its assistance with aid of one kind or another with a price tag attached to it. But Dominica had not chosen that route; instead it had sought to conduct its affairs within the resources available to it. That course had not been without cost; even though Dominica had a higher GDP per capita than other countries that would be eligible for assistance under the structural adjustment facility, that statistic was somewhat illusory because it did not make allowances for expenditure on capital projects and other items, which, although they were of great value to the island, did not mean a great deal in terms of present consumption. Thus, the figures suggested a higher standard of living than was justified by the facts. Indeed, Dominica was one of the poorer islands in the Caribbean region.

As Executive Directors had recognized, there was a need to accelerate balanced growth, which was precisely the aim of the authorities and one that they had manifested for some time, Mr. Leonard continued. The conditions under which progress would be achieved, as described by Mr. King, had for the most part been acknowledged by the authorities.

As to the role of the State in investment, he agreed with Executive Directors that when an economy was badly in need of development, every avenue of investment must be explored, Mr. Leonard commented. Even though there were no sure things either in commercial life or economic life, it was better in his view to try and pick a winner than not to try anything at all. If an honestly assessed and undertaken investment with a fair measure of risk failed, that failure should be viewed sympathetically. It was true, of course, that those in public service were often inclined to be cautious, and risk-taking could result in the loss of careers. However, the record of economic performance of many countries was a record of risks that had paid off. He therefore considered that if the private sector did not support projects in certain fields where there was reasonable opportunity for success, the state could rightly invest in those areas, but it could not expect others to pay if the project failed. The authorities thus had to look at the fiscal implications of failure and make some provision for it. He would be inclined to err on the side of considered risk-taking rather than be overly cautious.

The staff had adequately described Dominica's balance of payments need, Mr. Leonard considered. If Dominica had not had the kind of sound management that it had at present and had instead pursued a more rapid pace of development, it would have run into difficulties that would have made the underlying balance of payments need obvious indeed. Dominica was, of course, fortunate to have so many donors who were prepared to offer assistance.

The ECCB as an institution was at times a bit unwieldy and stiff in its procedures, Mr. Leonard observed. He recalled that in the past Directors had also remarked on the great need for the Caribbean islands to cooperate more, because individually they were unlikely to make the same progress as they would as a group. The ECCB represented at least one attempt by a number of islands to try to manage their affairs in a concerted way. In that regard it should be viewed as an achievement rather than a hindrance. It was a good institution that did valuable work. Efforts should perhaps be made to ensure that exchange rate flexibility was examined and acted on more often than it was at the present time.

Finally, as to whether Dominica should have a Fund-supported arrangement under the structural adjustment facility, he wished to point out that Dominica was in a sense an ideal candidate for Fund assistance: it did what was required, it was cooperative, and it managed its affairs well, Mr. Leonard remarked. However, its economy was largely stagnant and was not making remarkable progress. In determining the existence of a protracted balance of payments need, Dominica should be given the benefit of the doubt. The resources would be put to good use, and in the long run, the facility would yield tremendous benefits if countries like Dominica were treated generously.

The Acting Chairman, commenting on the possibilities of a greater role for private sector activity, remarked that one issue in that respect was the size of the economy. Dominica was a country of 84,000 people, and he wondered what were the limits on private sector activity in a small economy with a relatively small population, and whether the approaches available to the Government for managing the economy were also not limited. A question that Directors might wish to consider at some later stage was the critical mass needed for a country's private sector to be the engine of growth in the economy.

The Acting Chairman then made the following summing up:

Directors agreed with the main elements of the staff appraisal in the report for the 1986 Article IV consultation with Dominica.

Directors observed that over the last five years Dominica made sustained adjustment efforts that yielded significant economic gains, but the rate of growth of real GDP had temporarily slackened in 1985, and the rate of unemployment remained high. They noted with approval the authorities' aim to raise the rate of growth over the medium term in the context of policies directed toward strengthening the country's fiscal and balance of payments positions, containing the external debt burden within manageable proportions, and building up a cushion of reserves against external shocks.

Directors pointed out that achievement of sustainable growth and structural change in Dominica would depend crucially on the ability to raise domestic savings, private sector investment, and exports in the context of the continued pursuit of a cautious fiscal policy. With respect to the private sector, Directors felt that it was important for the Government to maintain a stable environment and remove any disincentives to private sector activity. To increase public sector savings, Directors recommended restraint on expenditure, the pursuit of an appropriate public utility rate policy, and improvements in the management and the financial position of the public enterprises. They emphasized that the authorities should exercise extreme caution in borrowing on nonconcessionary terms, so as to maintain Dominica's ability to service the public sector debt. Directors encouraged the authorities to intensify efforts to control wages, which are comparatively high, and to streamline the civil service. They supported the authorities' intention to reform the tax system with a view to reducing disincentives, but stressed that tax reform should not involve a loss of revenue. The World Bank's continued involvement in the improvement of the structure of the economy and in the assessment of investment planning and projects was welcomed.

Directors noted the real effective appreciation of Dominica's currency over the past five years. In this connection, as Dominica's scope for an independent exchange rate action is limited by its membership in the East Caribbean Central Bank, Directors underscored the importance of pursuing a prudent wage policy in order to strengthen the country's international competitive position and also the profitability of investment. It was also suggested that more attention be addressed to the impact of the exchange rate policy of the Eastern Caribbean Central Bank on the competitive position of Dominica as well as other members of the Bank.

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

3. JORDAN - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with Jordan (SM/86/206, 8/19/86). They also had before them a background paper on recent economic developments in Jordan (SM/86/238, 9/15/86).

The Director of the Middle Eastern Department said that in a communication to the staff received that week, the Jordanian authorities had indicated that they had taken several steps to revitalize the economy, including a new two-year government investment program, and new regulations aimed at restructuring the financial sector to enhance Jordan's role as a regional financial center and attract foreign capital. The authorities were also initiating policies, including a decision to privatize a number of public sector entities, with a view to promoting private sector investment. Moreover, they were reviewing the interest rate structure with the aim of effecting changes to encourage saving and investment. The staff was awaiting further details from the authorities before it could make an assessment of those measures.

Mr. Finaish made the following statement:

> The general economic slowdown in neighboring oil exporting countries over the last few years, and particularly since 1985, has had a significant impact on Jordan's economic performance. In addition to the fall in workers' remittances and the drop in external assistance, the decline in economic activity in the region, which constitutes the main market outlet for Jordan's exports, has led to a significant slowdown in export earnings. Given the fact that current account receipts amount to as much as 80 percent of Jordan's GNP, these developments have made it necessary for the authorities to focus their efforts on developing a broad-based policy response that would reorient the economy in line with the changed external environment. A proper evaluation of recent and present economic policy in Jordan has to be made against the backdrop of the broad objectives which the authorities are seeking to achieve through their adjustment strategy.
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> One main objective is to restore the rate of economic growth to a level which, although inevitably lower than that achieved prior to 1983, is more in line with the country's productive capacity and the rapidly growing labor force. The need to increase employment opportunities has been made more urgent by the growing number of Jordanian workers returning from oil exporting countries in the region, and the concern over immigration from the West Bank due to the policies of the occupying authorities. The Jordanian authorities recognize that the private sector has to play the major role in achieving the growth objective. This is not only in line with the authorities' overall approach, which has always emphasized private entrepreneurship, but is also necessitated by the decline in the resources available to the Government from

external assistance. However, in order to create proper conditions for stimulating productive activity by the private sector, the Government has an important role to play, particularly in the transitional period of adjustment.

Another major objective of the authorities' strategy is to strengthen the balance of payments structure in order to mitigate the pressures created by the regional economic slowdown and to reduce the vulnerability of Jordan's external position to the uncertainties relating to the regional economic environment in the future. Toward this end, the authorities are focusing on measures to promote exports of goods and services in which Jordan has a current or potential comparative advantage and to improve the marketing possibilities for those exports. At the same time, and in light of the general slowdown in the traditional markets for Jordan's exports, emphasis is also being put on import substitution, where feasible. Moreover, to help maintain the traditionally prudent approach to external borrowing, the authorities are taking steps to attract additional foreign investment.

A third objective of the authorities is to ensure that in the process of economic reorientation, domestic and external imbalances are kept at a manageable level so that the prevailing low rate of inflation is maintained and pressures on the exchange rate and the reserve position are minimized. At the same time, fiscal and monetary policies cannot be completely divorced from the other objectives already mentioned. The overall stance of macroeconomic policies has to be compatible with the broad adjustment strategy being followed, which aims at improving production and growth performance. What is needed, therefore, and what the authorities are trying to follow are financial policies that strike a balance between those various objectives.

In evaluating recent economic performance and the current policy stance, the staff has, in the view of the Jordanian authorities, failed to place the various policy issues in the broader context. While the authorities may agree with the staff on a number of specific policy questions, they have felt that the staff's analysis is generally too narrow. In some instances it provides only a partial view and ignores the broader picture. In addition, by exaggerating the difficulties facing the economy and downplaying the authorities' efforts to respond to those difficulties, the staff has painted a much darker picture than is warranted.

Let me now address some of the more important policy concerns emphasized by the staff.

The staff suggests that Jordan's adjustment to recent adverse developments has been "less than adequate." In the staff's view, this is indicated by the expansionary stance of fiscal policy, the slowdown in investment activity, the drop in official reserves, and the increase in external borrowing.

Regarding fiscal policy, the overall deficit was reduced significantly in 1985. The budget for 1986 aimed at further slashing the deficit by one half. That the deficit is now projected to be of the same order of magnitude as in 1985 is entirely explained by a large shorfall in revenues, reflecting both the slowdown in economic activity and lower external grants. Indeed, expenditures are projected to be lower than budgeted. If the budgetary outcome for 1986 is adjusted to take into account the fiscal impact of the present stagnation in income and output, it becomes less clear whether the fiscal stance can be termed expansionary. In assessing the present fiscal position, two other considerations are relevant. First, inflation has continued to decline in the recent period and is currently running at a very low rate. Second, the staff seems to overestimate the impact of the expected 1986 fiscal outcome on the external current account. The above, however, does not mean that the authorities hare happy with the current size of the deficit. Indeed, they expect that fiscal performance will improve significantly in the period ahead as economic activity picks up and an appropriately restrained approach is maintained with respect to expenditures. Of particular note with regard to expenditure policy is the reduction of subsidies and the freezing of wages and employment in the public sector.

It is true, as the staff suggests, that the brunt of the slowdown in the economy has been borne by investment. However, it should be noted that the level of investment in the preceding period had been exceptionally high. The recent slowdown in demand has led to excess capacity in many sectors. Under such circumstances it is natural for investment activity to decline. The authorities recognize, of course, the importance of investment for improving the growth potential and employment possibilities over the medium term. This recognition is reflected in the five-year plan (1986-90), which foresees a significant increase in investment activity during that period. In addition, the authorities have recently announced a new investment program totaling JD 125 million over a two-year period.

Regarding official reserves, I would like to make the following points. First, the Jordanian authorities have traditionally followed a prudent reserve policy as a result of which a comfortable level of reserves was achieved before the onset of the recent external pressures. The reserve drawdown which has taken place in the current adjustment process should not in itself be a cause for alarm. After all, external reserves are accumulated in good times in order to be used when needed. Of course, reserves are not inexhaustible and their use should be only supportive of, and not a substitute for, more fundamental adjustment policies. Second, as can be seen from Chart 4 of SM/86/206, most of the decline in official reserves has occurred on account of a special circumstance and, therefore, cannot be said to reflect weak financial and external sector policies. Third, the figures on reserves relative to imports provided by the staff exclude not only certain external claims but also the gold assets fo the Central Bank, which are substantial.

With respect to external debt, it is true that Jordan has increased its commercial borrowing over the last few years. This, however, should be neither surprising nor a cause for alarm. Countries undergoing balance of payments adjustment are expected to temporarily increase their recourse to external financing while the adjustment process is under way. The relatively low debt servicing ratio in the case of Jordan and its record in managing its external debt do not warrant the apprehensions which the staff appears to have on this issue. We all recognize of course that the experience of some other countries may have prompted the staff to be overly cautious in their assessment of developing countries' debt policies in general, but it is important that this cautiousness not be translated into a presumption that commercial borrowing should simply be avoided. In any event, the Jordanian authorities have clearly stated that their objective is to limit new commercial borrowing to an amount not greater than that needed to roll over maturing commercial loans.

Other policy issues that have been emphasized by the staff are the need to simplify and liberalize the interest rate structure and to adopt a more flexible exchange rate policy. On the first issue, the authorities are giving careful considration to the possibility of freeing interest rates. The cautious approach followed by the authorities on this issue stems from the fact that the present arrangement seems to be working fairly well and the financial sector has become accustomed to it. The authorities want to make sure that any institutional change in the interest rate system will not lead to unnecessary disruptions and will be compatible with the nature of the present domestic financial market. Even more important, the current interest rate policy is playing a positive role in domestic resource mobilization and in supporting the adjustment process. As Table 12 of SM/86/238 shows, both deposit and lending rates are significantly positive in real terms. As for the exchange rate, it has indeed become more flexible with the recent widening of the margins within which it is allowed to move. Moreover, in the period since the last Article IV consultation, the Jordan dinar has depreciated by more than 11 percent in real effective terms. The peg to the SDR has been useful in providing an element of stability and confidence, and thus has served the economy well.

Regarding the role of the public sector, the staff has urged that the tendency toward greater government intervention in the economy should be reversed. First, it should be made clear that the authorities consider the role of government in the economy as only a supportive one and that an open and liberal system in which the private sector plays the predominant role is the more suitable framework for growth and development in Jordan. Indeed, the recent steps taken by the authorities, and which have been interpreted by the staff as an indication of increased government intervention, are intended to create an environment that is more conducive to private sector activity. The process of economic reorientation which the authorities are seeking requires and can benefit from specific policy measures aimed at focusing and directing that process during the transitional period. These measures are therefore only temporary and are being used in a selective and careful manner. For example, the agricultural subsidies extended to certain commodities are intended to help speed up the production shift from surplus to deficit crops in line with the changing demand patterns in both domestic and export markets and will be phased out as these shifts occur. Similarly, the policy of controlling certain imports is designed to help the initial process of investment and production in areas of potential comparative advantage and is not intended as a permanent feature of policy. As the staff itself recognizes in its appraisal, most of the recent steps in this direction have been aimed at countering dumping or designed as a temporary expedient to foster the development of certain industries. The staff has suggested that an exchange rate adjustment could be a better substitute for some of these measures. It is difficult to see why a general devaluation should be preferable when the problem being addressed is not one of a general lack of competitiveness but of providing temporary support to a few specific industries.

Finally, the staff seems to be rather pessimistic regarding the medium-term outlook for the Jordanian economy and the achieveability of the targets under the Five-Year Plan. While it may be true that the uncertainties surrounding the regional economic situation make it difficult to predict with certainty the external constraints within which policy in Jordan will have to be conducted over the next few years, there are a number of positive factors which, though unquantifiable, should be kept in mind in judging the medium-term and longer-term prospects. First, the Jordanian authorities have demonstrated in the past their ability to cope with adverse situations and to steer the economy to a viable course in the face of difficult problems, including the regional security problems and, in particular, the loss of the West Bank. Second, for many reasons, Jordan is well placed to take advantage of the economic opportunities which still exist in the region despite the current slowdown. The oil exporting economies of the region will continue to require the type of services--such as maintenance activities and professional, technical, and financial services--which Jordan is capable of providing on an increasing scale. Third, the prudent and efficient manner in which the Jordanian authorities have utilized the foreign exchange inflows over the last decade provides an added reason for creditors and donors to continue assisting Jordan in the period ahead. Indeed, as has been mentioned in a World Bank report on Jordan issued last May, the country's record of prudent economic management is an important factor in its creditworthiness.

Extending his remarks, Mr. Finaish said that the authorities were not happy with the staff report: the general tone of the report was too apprehensive, the staff appraisal was unduly pessimistic, the assessment of the present state and medium-term prospects of the economy were less than balanced, and the staff had approached certain issues narrowly despite their economy-wide implications. His authorities also felt that insufficient attention had been paid to the dramatic changes that had taken place in the region, which affected Jordan's situation. Moreover, the important policy measures that had been taken to address that situation had not been sufficiently recognized.

The last paragraph of the staff appraisal, which dealt with the consultation cycle, was relatively long and unusual in insisting on a strict 12-month cycle, Mr. Finaish observed. The timing of the next consultation had become an issue during discussions between the staff and the authorities in Amman and again in Washington. Even though the authorities preferred an 18-month cycle, they had proposed a period of 15 months for the next consultations, but according to the staff, "this timing would probably result in an interval between consultations somewhat longer than the 15 months allowed under the standard 12-month cycle (plus grace period)." The staff had then recommended "that Directors reaffirm the importance of regular annual consultations with Jordan in present circumstances." In his view, the consultation period should not be overemphasized, especially as the guidelines are not precise and in view of the complaints within the Board about the amount of time devoted by Directors to consultations. For example, in 1985 33 percent of the Board's time had been devoted to consultations compared with 17 percent in 1984.

For all those reasons, his Jordanian authorities were sensitive about the manner in which this matter had been raised and felt there was no need to devote so much attention to it, Mr. Finaish remarked. In his view, the statement in the staff report was neither proper nor wise but amounted to imposing a Fund mission on a country before its authorities considered a consultation was warranted. He therefore would not recommend that the Board adopt the staff's views with respect to the consultation cycle for Jordan.

Mr. Suraisry made the following statement:

> Over the past decade Jordan has experienced a high rate of economic growth and low inflation, and at the same time has supplied the region with a pool of highly skilled labor. The authorities' sound policies have greatly contributed to the good economic performance and to the strength in the fiscal and balance of payments positions. More recently, however, a number of adverse external developments have complicated economic policies and have introduced new challenges to the Jordanian authorities.
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> The substantial slowdown in economic activity in the region and the associated fall in demand for Jordan's goods and labor services have reduced export earnings and have led to the repatriation

of a significant number of Jordanian workers. The growth of export earnings has also been hindered by the weakness of the prices for Jordan's major commodity exports. These adverse developments occurred at the same time as a fall in Jordan's external grant and aid resources. Clearly, the sharp turnaround in the external environment has called for an adjustment in economic policies. In this context, I agree with Mr. Finaish that recent developments have made it necessary for the authorities to focus their efforts on developing a broad-based policy response which would orient the economy in line with the changed external environment. The main challenge facing the authorities at this time is how to cushion the adverse effects of such a large fall in external earnings, absorb higher employment, and at the same time, reduce the domestic and external imbalances so as to establish the conditions necessary for resumption of sustainable growth over the medium term. It is encouraging in this context that the authorities have taken a number of demand management and supply-side measures.

In the fiscal area, they have reduced total subsidies financed through the budget from 9 1/2 percent of total current budgetary expenditures in 1984 to 6 1/2 percent in 1985. Furthermore, a decline in budget-financed subsidies to 2 percent of current expenditures is also under way, and wages and salaries of government employees continue to be kept under control. However, despite these efforts to strengthen the structure of public finances, the overall fiscal deficit has remained high. The authorities' desire to revive domestic activity is understandable, but the present trend in fiscal expansion may complicate the needed adjustment, and, in particular, may further weaken the balance of payments. In my judgment, there is a need to reduce the fiscal deficit so as to ensure medium-term balance of payments viability. In the monetary area, the authorities have made commendable efforts to strengthen the financial system and redirect resources toward productive investment in the private sector. Beginning in 1986, they have raised the minimum capital base for the commercial banks, strengthened banking supervision, and introduced guidelines for provisioning. A strong, sound financial system is clearly a cornerstone to growth in the private sector. The authorities' attention to this area is commendable. I am pleased to note from the staff report that despite an inevitable increase in the cost to banks, some banks have in fact improved their profit positions.

In the external sector, the authorities have increased export volumes of major exports and have restrained imports. As a result, the balance of payments projection for 1986 is likely to show some improvement in the current account deficit. However, as the authorities recognize, the current budgetary trends add a measure of uncertainty to the balance of payments outlook. It is encouraging that the authorities plan to keep demand management policies under close and continuing review. It is clear from the staff report that the authorities have been successful in diversifying their export production and markets. However, in view of the medium-term outlook, more efforts are needed in this direction. I am therefore pleased to note that a number of steps have already been taken to encourage exports, including the reduction in interest rates on export financing, the provision of support facilities for marketing Jordanian products abroad, and greater flexibility in exchange rate policy. However, shrinking markets in the region and stiffer competition may require more flexibility in exchange rate policy so as to maintain and, indeed, increase Jordan's market share in its traditional markets and penetrate new ones.

The authorities have so far followed a cautious external debt strategy, which is reflected in their low debt service payments. This prudent approach is commendable and should be continued. In this context, I welcome the recent efforts to enhance nondebt-creating foreign capital flows. The liberalization of foreign investment laws and the recent signing of the Multilateral Investment Guarantee Agreement are but two examples of the authorities' determined efforts to attract foreign capital to finance their development program without increasing their external debt service payments. Again, these efforts bear witness to the authorities' prudent approach to external debt management.

Finally, while I see merit in the 12-month consultation cycle, I believe it is prudent to take into account the authorities' wishes for a slightly longer period. I wish the Jordanian authorities every success in the task ahead and endorse the proposed decision.

Mr. Msadek made the following statement:

The performance of the Jordanian economy since the last Article IV consultation continues to be under stress owing to the changing external environment and domestic structural rigidities. As Mr. Finaish has indicated, the authorities reacted fairly early to these changes and introduced a number of measures aimed at redressing the fiscal and external situations. The scope of the measures implemented has been gradually reinforced so as to restore the desired equilibrium in the medium term. The relative decline in economic activity in neighboring countries following the fall in oil prices has reduced Jordan's inflows of resources from trade and workers' remittances and has led to pressure on the balance of payments. Likewise, export receipts from phosphates are declining because of slackening demand and low prices as a result of world overproduction. Finally, the security situation in the region hampers the free flow of trade and tourism, which are essential for the buildup of Jordan's foreign reserves.

The 1986 Article IV consultation focused on the need to examine the country's economic prospects in the light of the changing external environment and to define the adjustment measures necessitated by recent developments in the Jordanian economy. Throughout 1985, economic activity continued to slow down owing to the decline in net income from abroad. Although the agricultural sector registered improvement in output of about 17 percent over a year previously, the manufacturing and mining sectors continued to be affected by the relative recession in neighboring countries and low commodity export prices. Likewise, construction, which is usually stimulated by workers' remittances and foreign assistance, showed a decline in 1985. At the same time government expenditures increased, reflecting the greater need for government spending. The reduced aid flows also affected gross investment, which stagnated in 1985. The ratio of gross domestic investment to GNP declined from 37 percent in 1982 to 26 percent in 1985, reflecting both reduced resources and a more careful and rational approach to investment.

In other areas, declining job opportunities in neighboring countries created pressure on domestic employment as emigrant workers started returning home. Greater attention is being given by the authorities to job creation. Wages remained stable in 1985 and 1986 in the private sector, and government employees had been awarded an increase of 10 percent to 25 percent, the first across-the-board increase since 1981. The price structure in Jordan declined in 1985 on account of lower import prices. The authorities also maintain a system of price monitoring for basic foodstuffs as well as for essential services.

While the objectives of the last development plan, covering the period 1981-85, was set within the capability of the Jordanian economy, real performance has been somewhat dampened by the unexpected downturn in the economies of neighboring countries, causing a slowdown in the demand for Jordanian goods and services as well as a decline in foreign financial assistance. While revenues remained unchanged in 1985, current expenditures rose faster than targeted and the overall deficit was higher than expected--at 8.1 percent of GDP--but still lower than that of the preceding year on account of grants. The deficit has been financed entirely from foreign sources on concessional terms.

The new five-year development plan for 1986-90 has been adapted to the changing economic circumstances and calls for a real rate of growth of GDP at a factor cost of 5 percent on average, with consumption increasing at a rate of 4 percent and investment at a rate of 5.4 percent. By comparison, the 1986 budget called for a substantial increase in revenues and a moderate rise in expenditures, thus leading to a substantial reduction in the budget deficit and the current account.

The role of monetary policy also has been adapted in recent years to reflect a more cautious stance with a view to improving bank assets following the economic slowdown and a more efficient allocation of credit through a dampening of consumer demand. In 1986 credit policy was further tightened and credit was directed more efficiently toward the productive sector. To encourage inflows of workers' remittances, deposit rates have been raised and, with a substantial decline in inflation, real interest rates have increased.

The application of a tighter monetary policy is helping in turn to conserve foreign exchange reserves. Balance of payments projections for 1986 point to a lower current account deficit as a result of higher exports and lower prices for imports. Notwithstanding the small surplus projected for 1986 at the level of the balance of payments, a cautious external borrowing policy is being maintained in order to prevent an excessive accumulation of foreign debt.

The competitiveness of the exchange rate is also being closely watched as pressure on the balance of payments develops owing to reduced grants and remittances. The prospects for the medium term are covered in the new five-year development program for 1986-90. While the Fund staff considered an annual rate of growth of 5 percent to be high, the anticipated movement in the rate of investment and exports, along with measures to mobilize savings and direct them toward productive export-oriented industries, could justify the authorities' growth objective. However, consumption--private as well as public--will have to be curtailed.

Regarding the external sector, the authorities are fully aware of the need to avoid an excessive accumulation of foreign debt. For this reason, they are keen on developing domestic resources through savings, expenditure cuts, and reorienting the investment effort toward exports. Where competitive advantage is evident, import substitutes are being encouraged. Thus it is expected that the balance of payments at least through 1988 would maintain a surplus on account of favorable behavior in the trade and services balance, while the capital account balance would merely reflect the borrowing needed to roll over loans.

The adjustment program incorporated in the authorities' new five-year plan is thoughtfully designed to reorient the economy toward greater use of existing productive capacity and to lessen the dependency on transfers and grants from neighboring countries, and thereby re-establish a balanced economy. The need to restore domestic financial soundness is evident in the improvement of bank operations and the reorientation of credit toward the productive sector, particularly as it improves trade and helps rebuild the country's reserves.

The Jordanian authorities have an excellent record of economic management and I trust that, in light of the staff's statement at the beginning of the meeting, the new measures adopted will be pursued with the necessary determination to overcome the present financial disequilibria. Regarding the consultation period, inasmuch as Jordan had been on an 18-month cycle until recently, a return to that cycle is warranted so as to provide the authorities continuity in their economic assessment. Finally, I support the proposed decision.

Mr. Jayawardena made the following statement:

In the past Jordan has made steady economic progress with prudent economic management. Recently, however, the recessionary conditions that have emerged in the region, with which the Jordanian economy is closely interlinked, have created many difficulties. The staff has no doubt highlighted the problem areas, which has apparently led to some misgivings among the Jordanian authorities, as was evident from Mr. Finaish's statement.

The real situation in Jordan would probably lie somewhere between the position of the staff and that of the authorities. The staff deserves our thanks for underlining the structural nature of the problem and the need to diversify the economy so as to make it less dependent on external transfers and more oriented toward production and export in areas with a clear competitive advantage. We think that the staff is justified in drawing the inference that more recent policy reaction to the weakening external situation has been inadequate. According to Mr. Finaish, these policy responses are mostly temporary measures undertaken to meet specific microeconomic problems--for example, the trade restraints to counter unfair practices--and he assures us that the authorities will consider all other longer-term policy options as soon as possible. The authorities want to be mindful of the possibility of further deterioration in Jordan's traditional markets; and a rededication to the open market policies of the past--which yielded positive results--might prove helpful.

As to the consultation cycle, if I were from Jordan, I would welcome the shortest possible cycle, because the consultation process is a valuable opportunity to hear the considered views of others who are interested in the country's economy. However, the authorities seem to prefer an 18-month cycle, whereas the staff has suggested the standard 12-month cycle--probably because of emerging economic difficulties. It is important to remain flexible in determining the periodicity of Fund consultations and every endeavor should be made to accommodate the authorities' wishes. After all, there must be good reason why the authorities suggested a certain date. Consultation is a two-way process and both parties must approach the consultations in a constructive manner.

Looking at the recent record, I wonder whether a problem actually exists. In 1985 the consultations in Amman were held in March, and the Board discussion was held in June, at which time it was decided to have the next consultation in "approximately 12 months." In 1986, consultations were held in Amman in July, and the Board discussion is being held in October. Thus the term "approximately 12 months" has meant an interval of 15 months between consultations as well as between Board discussions. Moreover, although the authorities have asked for an 18-month consultation cycle, they have also indicated that October 1987 would be a suitable time for consultations in Amman--or 15 months after the previous consultations in Amman. The Board discussion could take place in December 1987 or January 1988--approximately 15 months after the Board's last discussion. Thus, there seemed to be no problem: if the Board once again decided that the consultation should be held in approximately 12 months, and allowing for the 3-month grace period, the consultation could then take place on a 15-month basis, which would no doubt satisfy the Jordanian authorities.

Mr. Rye remarked that he wished to support Mr. Finaish and the Jordanian authorities on the question of the timing of the next Article IV consultation. Delaying the consultation until October 1987 did not seem at all unreasonable. The Jordanian economy was not a major regional influence, and in the circumstances, the Board should take a flexible approach. Moreover, any offer to reduce the work load on the staff and the Board, however marginally, should be welcome.

Mr. Hospedales said that he also wished to support Mr. Finaish's request that due consideration be given to a longer consultation cycle for Jordan.

Ms. Bush made the following statement:

Since the last Article IV consultation with Jordan, a number of trends have emerged that point toward some fundamental changes in economic patterns. The most obvious of these changes are the decline in foreign grants and the weakening of export markets, which are related to economic developments in neighboring countries. In addition, workers' remittances may be reaching a peak, with prospects for future declines as workers return home. Some of these factors may already have affected the growth rate. Furthermore, in view of the low level of foreign exchange reserves--covering only about six weeks of total imports--concerted action to prevent external and internal economic deterioration appears to be in order. In that regard, we would recommend that efforts be made to control the overall fiscal deficit as well as to address some structural imbalances in the economy. Emphasis on both these fronts could prevent the emergence of financial difficulties and at the same time strengthen the potential for higher growth in the medium term. In that context, the authorities' intentions to put into place a broad-based policy response so as to cushion the adverse effects of these developments is very important at this point.

The incipient move toward expanded reliance on economic controls on prices and production as well as on some imports is cause for concern. While the authorities have not opted for full-scale control of internal and external activity, care should be taken to avoid the gradual implementation of various controls, which individually might not be major sources of distortion, but which might in the aggregate turn the economy excessively inward and lead to an inflexible predetermination of resource allocation. We continue to believe that reliance on market forces would be a much more effective means for determining resource allocation. In that regard, the authorities' efforts to attract more foreign investment indicate that they are aware of the benefits that accrue from an open economy, and we urge them to keep those benefits in mind when evaluating other measures. Emphasis on an open economy would also be consistent with the development of the private sector, which is an objective that the authorities are stressing.

The continuing large fiscal deficit--at about 9 percent of GDP--is a matter of concern because it cannot be readily financed from historic external sources. Although expenditures would be somewhat lower than budgeted, the authorities had recently turned to foreign borrowing on commercial terms. While Jordan's debt service ratio is still manageable--at about 10 percent of exports of goods and services--it could grow quickly if large gaps in the budget are financed with nonconcessional borrowing. In that regard, we note that in the three years from 1982, external commercial debt more than tripled. The authorities plan to use fiscal policy in a countercyclical manner to offset the adverse effects of developments in the external sector on aggregate demand. If, however, these external developments reflect longer-run trends, such a policy could be counterproductive and lead to excessive contraction in the future if available financing was exhausted. Relatively few details are presented in the staff report on possible areas of consolidation, and we would be interested in the possibilities for economies on current expenditures, which exceeded 34 percent of GDP in 1984.

Regarding the monetary sector, the authorities are taking some prudent steps to strengthen the financial position of institutions. We are not certain, however, if some of the efforts to channel credit, including the agreements with foreign banks, are the best means of promoting more investment and growth. Instead, a more generalized credit policy, as well as a review of interest rate policy, could encourage the financial sector to become more responsive to the needs of the productive sector. The news that the authorities would be reviewing interest policy, with a focus on encouraging saving and growth, was therefore welcome.

The staff has recommended a more flexible exchange rate policy to encourage production of tradables while helping to contain the overall external deficit. In that regard, the real effective exchange rate has depreciated this year. However, if large payments imbalances persist, what further role might exchange rate adjustment play in addressing those imbalances and promoting export diversification?

The staff's discussion of the medium-term outlook indicates that comprehensive policy actions are required if economic contraction and large increases in external debt are to be avoided. *In that regard, we welcome the authorities' intention to implement* broad-based policy actions. The World Bank appears to share the view that strong measures to promote increased resource mobilization and more efficient utilization of domestic resources are in order. We urge the authorities to consider that advice and welcome the staff statement that the authorities will be taking some steps in that direction. We hope that the authorities would consider it useful and beneficial to receive the views of the staff and the Board more, rather than less, frequently, particularly at a time when economic problems have emerged.

The staff representative from the Exchange and Trade Relations Department remarked that it had been agreed with the authorities that the next consultation could be held in October 1987, or in about 15 months, which was within the grace period allowed for 12-month consultation cycles. In view of the changes under way in the economy and the external exogenous shocks being experienced, the staff had recommended a shorter cycle so that the Board would have updated information on conditions in Jordan. The suggestion that the cycle be shortened was not meant to imply any negative judgment. The length of the consultation cycle was not at issue, but it would be important to remain up to date on developments under current circumstances.

Mr. Finaish commented that although his authorities were not happy with the staff report, they did not mean to imply that the staff's views and suggestions on certain policy issues were not useful or helpful but rather they wished to underline their concern about the general tone of the report.

In view of the dramatic changes in the region, which were important for a country whose current account receipts represented about 80 percent of GNP, it might be helpful to know how the Jordanians viewed their present situation, Mr. Finaish considered. A recent speech given at the

University of Jordan by Crown Prince Hassan on September 14, 1986, and an interview with the Prince in the Institutional Investor, described how the Jordanians intended to reorient their policies:

> Historically, Jordan's importance has stemmed from its central geographical location and its pivotal role as a bridge between neighboring communities. Our hope now is to revive the concept of trilateral cooperation between the resources of the Gulf, Jordanian manpower and location, and European expertise.
>
> With respect to the Gulf economies, we hope to develop a process of contract regeneration whereby Jordanians who participated in the construction of huge projects and facilities can now play a key role in servicing and maintaining these facilities. As a transient and communications hub for the entire eastern Arab world, Jordan is now in a position to export a whole range of quality services and commodities, including electronics, pharmaceuticals and health care, as well as the country's extractive and agricultural products. We also want to see Gulf investors working jointly with Jordanians to develop downstream petrochemical industries, creating regional complementarities and economies of scale.
>
> With an excellent infrastructure and manpower skills, Jordan will now concentrate on marketing, product development, and quality control. Our new five-year plan covering the period 1986-90 will stress the "softwares" facet of the management of development, rather than the acquisition of additional "hardware."
>
> The strategy Jordan will pursue in the second half of this decade is embodied in the new five-year plan. Jordan will continue to expand its mining industries and its agricultural potential, especially through new agribusiness ventures that will draw on underground aquifers. But the plan will concentrate on developing Jordan's role as a regional center of finance, light industry, and high-tech services. The Kingdom will continue to provide skilled labor to the Gulf States, which need technical and managerial cadres to service and maintain the huge projects and facilities built during the 1970s. Jordan will also try to find new markets for its industrial products, minerals, and foodstuffs.
>
> We also need to make use of our strategic location between the Arab region and the European Common Market and to utilize existing facilities for Jordanian exports to this market. It is known that petrochemical exports from the Gulf Cooperation Council states to the European Common Market face many restrictions. In this field, Jordan could benefit from its relations with both areas by establishing chemical industries that use raw materials from friendly oil producing countries and then export these products to the Common Market. About 25 industries that can be established in Jordan on this basis have already been defined.

Although the situation in the Gulf countries and in the oil exporting countries had changed, the infrastructure was still there and required maintenance and servicing, Mr. Finaish commented. Almost 350,000 Jordanians had participated in the 1970s in building that infrastructure. At present, Jordan's role was to compete with others to maintain and service that infrastructure. It had concentrated on education; it had three universities, as well as almost 60,000 students abroad, with 15,000 students in the United States. Moreover, in the absence of Beirut, Amman was an important financial center. The Jordanian authorities would be using all those assets intelligently.

The Acting Chairman made the following summing up:

Directors commended Jordan's past record of sound economic management and impressive economic progress with relative price stability and a sound external position over many years.

Directors recognized the difficult situation that had emerged in recent years following the major change in Jordan's external environment and the related virtual stagnation in the economy and the rise in unemployment fed by workers returning from abroad. They noted that the current objectives of the Jordanian authorities were to restore the rate of growth, to strengthen the balance of payments structure, and to reduce internal and external imbalances. Nevertheless, Directors believed that an early resumption of rapid and sustainable growth was not readily within grasp. Given the existing weaknesses in the external payments position and the difficult medium-term prospects, Directors advised the Jordanian authorities to steer a careful course and to attach high priority to the maintenance of internal and external balance. In this connection, Directors emphasized the importance of appropriate budgetary restraint. While commending the authorities for revenue measures already taken and also for reducing subsidies, Directors felt that further steps, including stronger restraint on current expenditure outlays, would be needed to bring the fiscal deficit more closely in line with that envisaged in the original 1986 budget. A tighter fiscal stance would also open the way for more active exercise of monetary policy in support of an appropriate degree of demand restraint.

Directors fully recognized the scale of the task now confronting the authorities in fostering the needed structural changes in the economy. To this end, an increase in the efficiency of investment, enhanced domestic resource mobilization, the encouragement of foreign investment, and further progress in developing and diversifying the export sector were all essential elements of a sound medium-term growth strategy consistent with efficient employment creation and external equilibrium. Directors welcomed the recognition by the authorities that the achievement of these goals necessitated broad-ranging policy action. They noted in particular the recent measures to strengthen the domestic financial system and the authorities' plan to review the interest rate system. Directors also emphasized the need for enhancing domestic revenue and for greater flexibility in the implementation of exchange rate policy. They cautioned against increased intervention in the economy. The authorities were strongly encouraged to continue their traditional cautious policy with regard to foreign borrowing.

Taking into account the views of the Jordanian authorities and those expressed by Executive Directors, it is proposed that the next consultation discussions with Jordan be held not later than October 1987.

The Executive Board then took the following decision:

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

2. The Fund notes that Jordan continues to operate a liberal exchange system.

Decision No. 8424-(86/171), adopted October 17, 1986

4. EXECUTIVE DIRECTOR

The Acting Chairman bade farewell to Mr. Leonard at the conclusion of his service as Alternate Executive Director.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/86/170 (10/15/86) and EBM/86/171 (10/17/86).

5. PHILIPPINES - TECHNICAL ASSISTANCE

In response to a request from the Philippine authorities for technical assistance in the tax field, the Executive Board approves the proposal set forth in EBD/86/271 (10/10/86).

Adopted October 16, 1986

6. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of an Assistant to Executive Director as set forth in EBAP/86/243 (10/10/86).

Adopted October 15, 1986

7. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of an Assistant to Executive Director as set forth in EBAP/86/245 (10/14/86).

Adopted October 16, 1986

8. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 86/28 and 86/29 are approved. (EBD/86/268, 10/9/86)

Adopted October 16, 1986

9. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/86/244 (10/14/86) and EBAP/86/247 (10/15/86) is approved.

APPROVED: June 18, 1987

LEO VAN HOUTVEN
Secretary