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04 INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/139

3:00 p.m, August 27, 1986

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	Mawakani Samba
	E. L. Walker, Temporary
	M. Lundsager, Temporary
	L. Hubloue, Temporary
	M. B. Chatah, Temporary
	T. Morita, Temporary
	W.-R. Bengs, Temporary
Huang F.	
J. E. Ismael	
	J. Hospedales, Temporary
T. P. Lankester	S. King, Temporary
	O. Isleifsson, Temporary
	G. D. Hodgson, Temporary
	A. Abdallah
	C. A. Salinas, Temporary
	A. Ouanes, Temporary
	J. E. Rodríguez, Temporary
H. Ploix	
	G. Schurr, Temporary
	A. V. Romuáldez
	A. A. Agah, Temporary
	V. Govindarajan, Temporary
	L. Tornetta, Temporary

J. W. Lang, Jr., Acting Secretary
B. J. Owen, Assistant

Also Present

IBRD: R. J. Robinson, Latin America and the Caribbean Regional Office. African Department: G. E. Gondwe, Deputy Director; L. D. Dicks-Mireaux, A. Oloyede, M. A. Pinho, S. L. Rothman. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director. Legal Department: P. L. Francotte. Western Hemisphere Department: M. Caiola, E. V. Clifton, J. Ferrán, G. R. Le Fort, L. L. Pérez. Bureau of Statistics: M. J. Ellyne. Assistants to Executive Directors: A. R. Ismael, J. A. K. Munthali, S. Simonsen.

1. DJIBOUTI - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with Djibouti (SM/86/159, 7/1/86). They also had before them a report on recent economic developments in Djibouti (SM/86/191, 8/6/86), together with an information notice on the real effective exchange rate of the Djibouti franc (EBS/86/197, 8/22/86).

Mr. Mawakani made the following statement:

> The economic and financial situation of Djibouti has remained difficult in 1985, as evidenced by the continued slowing down of economic growth, the persistence of a sizable fiscal gap and a large external current account deficit. On the other hand, domestic credit expansion decelerated and inflation, as measured by the rise in the consumer price index (CPI) remained relatively low despite the depreciation of the Djibouti franc. The Djibouti authorities are aware of this situation and are taking measures to address it.
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> In the productive sector, real GDP was virtually stagnant in 1985, mostly as a result of a decline in commercial construction activities. The contribution of the service sector was not sufficient to prevent the decline in total output. The agricultural sector, while still relatively small, continued to expand in 1985. Under the Program for Rural Development which was started in 1981, output of fruits and vegetables increased more than fourfold between 1981 and 1985. The development of the fishing industry is also proceeding satisfactorily. Here, as noted by the staff, the problem is more on the demand than on the supply side. The authorities are studying the possibility of exporting the surplus to neighboring countries.
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> For 1986, the downturn in economic activity is forecast to continue, mainly as a result of a marked slowdown in investment projects and continued stagnation in the construction industries. Commercial activities are also expected to be adversely affected by rising inflation. However, the investment made in the service sector is expected to make a positive contribution to the economy in the coming years. Efforts to increase agricultural production are being pursued and the marketing network is being improved. The authorities are encouraging industrial development by providing the private sector with the necessary technical assistance. Emphasis is also being placed on expanding export activities, given the rather limited absorptive capacity of Djibouti's economy.
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> Developments in the fiscal sector were affected by the stagnant economic activity and by a sharp decline in grants. On the expenditure side, despite the authorities' rather tight control measures, total outlays increased by about 4 percent in 1985.

While capital expenditures fell, there was an increase in current expenditure brought about by wage drift associated with an increase in the number of government employees. Expenditure on other goods and services also rose. In order to reduce the impact of increased expenditure and the decline in grants on the overall budget, the authorities took several revenue-increasing measures in 1985. These include increased duties on some imports, and higher taxes on automobile and audio-visual equipment. However, continued weakness in the economy affected revenue growth and thus the overall fiscal outcome. For 1986, the fiscal measures introduced in mid-1985, together with the continued depreciation of the Djibouti franc, might exert a favorable influence on the budgetary performance. However, the liquidity position of the Government will remain difficult. Consequently the authorities are monitoring the situation very closely.

In the public enterprise sector, progress was made in improving the financial performance of some enterprises but others continue to face financial difficulties. The Djibouti authorities, with French assistance, have completed a study of the financial situation of some public enterprises. The results are being examined with a view to taking appropriate measures.

Monetary policy was restrained in 1985 as overall credit expansion slowed down considerably, partly as a reflection of the weak performance in the real sector and the stronger inflationary pressure. Institutionally, the supervisory authority of the National Bank was enhanced with a view to increasing its control over monetary and credit policies. For 1986 the stance of monetary policy is expected to be moderate.

Djibouti's external position in 1985 remained under pressure. While net transfers increased moderately, the trade balance weakened and net service payments remained unchanged from their 1984 level. The increase in net receipts from transportation services resulting from the coming into full operation of the container terminal was offset by higher interest payments on the external debt and a decline in investment income. Capital inflows also declined, leading to a worsening of the overall balance in domestic currency terms. The current account deficit as a percentage of GDP is not forecast to show much improvement in 1986 in spite of a reduction in project-related imports. Other imports, too, are expected to fall as a result of the depreciation of the Djibouti franc, so that the trade deficit is forecast to be reduced. However, the surplus on the services account is forecast to decline because of the weaker commercial and economic activity that is projected. The capital account is forecast to remain virtually unchanged.

Djibouti's external debt has remained manageable, although it has been rising in recent years as a result of borrowing to finance investment projects. However, the authorities are aware of its implications for the medium and longer term and are, therefore, increasing their efforts to secure external assistance on concessional terms. They also hope that foreign donors will continue to provide them with much needed financial assistance in the form of grants to develop Djibouti's economy.

Mr. Abdallah made the following statement:

Djibouti is a country poorly endowed with natural resources and very limited agricultural potential. A major contributor to the gross domestic product is the service sector, which also generates most of the country's foreign exchange earnings. With a population of less than half a million, confined within an area of just over 23,000 square kilometers, Djibouti indeed has limited scope for increasing the size of its domestic market. Yet the economy has performed fairly well. For example, it has been possible to avoid price controls while maintaining a liberal exchange and trade system. This has no doubt helped to promote an efficient allocation of resources. Furthermore, the authorities have managed to raise as much revenue as possible from a very narrow base.

However, in recent years, the economy has experienced growing internal and external imbalances and the prospects for 1986 are not encouraging. The major problem appears to arise from the government sector where expenditures on administrative services and defense have risen considerably. Thus, despite the measures taken to raise revenue, the fiscal position shifted from a surplus of 4.3 percent of GDP in 1981 to deficits of about 6 percent of GDP on average between 1982 and 1985, with the prospect of a larger deficit of 8.4 percent of GDP in 1986. The authorities are naturally concerned and have tried to contain expenditure growth by taking measures to raise additional revenue. As a result, government revenue now constitutes a rather large proportion of GDP, and I therefore agree with the staff that further restraint in expenditure is required.

Another area of concern in the public sector is the financial situation of state enterprises. There are indications that the financial position of these corporations has been weakening over recent years as evidenced by the accumulation of arrears on their payments to the Government and other creditors. Furthermore, the Government has had to assume the servicing of the corporations' external debt. I therefore agree with the staff that new investments should pay more attention to generating foreign exchange earnings. In other words, the authorities should not only direct their efforts at exploiting the domestic market, which is very small, but should venture into export markets either within the subregion in which the country is situated or further afield. Since the scope for doing so may be limited, the Government would be better advised to encourage the private sector to play a more active role, as has been suggested by the authorities themselves. Such a strategy would certainly reduce the risk of the Government undertaking ventures that might later prove to be a drain on its resources. I also support the view that the authorities should complete the review of a study on public corporations that was undertaken with French assistance and that is likely to recommend corrective measures to arrest any further deterioration in their performance.

Finally, I note that the authorities intend to explore the possibility of using Fund resources under the structural adjustment facility. However, I have formed the impression, perhaps wrongly, that they are somewhat reluctant to adopt an adjustment program that will involve the use of both Bank and Fund resources. I hope I am wrong as I would consider this to be necessary in view of the low per capita income and resource base of the economy.

Mrs. Ploix said that she was in broad agreement with the staff report and with Mr. Abdallah's remarks. She also supported the staff's commendation of the authorities' recent policy reorientation, which Mr. Mawakani had described in his opening statement. However, the size of the current imbalances, and the less than favorable external account prospects caused her to stress the areas where a tightening of policy was needed--more specifically, with respect to fiscal, wage, and external policies.

On fiscal policy, the continued excess of expenditure over budgetary receipts plus grants was an area of great concern, Mrs. Ploix continued. She supported the staff recommendation of a restructuring of current expenditures and a more rigorous selection of public investments. Some projects that were mentioned did not seem very essential, such as the road construction project and the extension of the airport. The World Bank could be of great help to the Djibouti authorities in monitoring the public investment program. She strongly advocated a closer working relationship with the World Bank, to include taking the World Bank's advice. In addition, she was concerned to learn that the results of the study on the public enterprise sector were still being examined by the Djibouti authorities even though the situation in that sector was known to be very serious.

As for wage policy, the staff had made it plain that the wage drift had had three severe consequences, Mrs. Ploix observed. Budget expenditures, domestic demand and the balance of payments, and competitiveness had all come under pressure. She urged the Djibouti authorities to make every effort to encourage wage restraint and to promote a competitive environment.

She understood from the staff report that "the underlying problem for Djibouti was its already rising stock of external debt and levels of debt service obligations relative to foreseeable increases in its foreign exchange earning capacity," Mrs. Ploix concluded. That situation called for the limitation of nonconcessional borrowing and further emphasis on export-oriented policies.

Mrs. Walker made the following statement:

Djibouti's economic outlook for 1986 is characterized by little pickup in real economic growth, an increase in inflation, growing imbalances in the central government finances and balance of payments, and an increase in debt service obligations. Furthermore, the staff projects an unsustainable overall balance of payments deficit in the medium term with the possibility that foreign exchange reserves could be exhausted by 1988. The authorities recognized the economic difficulties they face in the medium term and have begun to take some measures to improve the outlook for the economy. Particularly encouraging are the steps taken to expand certain sectors of the economy--agriculture and fishing--in addition to efforts to further enhance the services sector. We welcome the Government's encouragement of private sector initiatives to replace direct intervention in the industrial sector. The improved role of the National Bank of Djibouti should also be helpful, particularly if efforts to strengthen bank supervision and improve statistical collection succeed.

Nevertheless, given the outlook for the Djibouti economy, additional steps should be taken in several areas in order to improve the prospects for the medium term. First, in the fiscal area, in spite of measures to increase revenue in 1985, the central government deficit (after grants) widened to 6.5 percent of GDP and projections show that it will be 8.4 percent of GDP in 1986. Current expenditure is projected to increase by 6.4 percent. The authorities were aware of the fiscal prospects and, according to Mr. Mawakani, they were monitoring the situation closely. The staff report stated that they would implement cuts in expenditure as deemed necessary. I would appreciate any clarification of the apparent difference between the perception of the staff and Mr. Mawakani with respect to the authorities' commitment to reducing government expenditure in 1986.

We concur with the staff assessment that the fiscal problem is really a longer-term structural problem and that an overall restructuring of the budget may be warranted. Tax revenues as a percentage of GDP are already very high and emphasis on expenditure restraints is therefore called for. The Government's wage bill is also large, exceeding 60 percent of total current outlays, and warrants reduction.

In addition, attention should be given to public sector investment. The World Bank has concluded that public sector investment overall should be contained within Djibouti's capacity to implement and finance, with the program being directed more to achieving the goal of economic diversification. The staff report on recent economic developments points in this direction by concluding that inadequate feasibility studies had been performed for many individual projects in the Public Investment Program (PIP), and donors have withheld funding on these grounds. Furthermore, in some cases inadequate planning has caused financial problems following the completion of projects. In light of those considerations, we believe that a thorough review and possible revision of the public sector investment program is called for.

Reform of the nonfinancial public sector enterprises has been on the horizon for some time but no action appears to have been taken to date. While I recognize that public enterprise operations are not included in the central government budget and that their investment program has been financed almost entirely by external loans and grants, they receive substantial indirect subsidies from the Government, according to the staff report. Furthermore, it appears that in the aggregate these enterprises are facing increasing financial difficulties. In this connection, I urge the authorities to implement the measures included in the recently completed review of the sector.

We note that both the Fund and the Bank staff have expressed the need to study the possibility of a more active and flexible exchange rate policy for the longer term without eroding confidence in the economy. I would appreciate further staff elaboration on the need for and effects of such a policy.

Finally, I have pointed to several areas calling for additional attention, including the fiscal area, public sector investment, and public enterprises, and I expect that these would be included in any structural adjustment arrangement that might be negotiated. In that respect, close Bank/Fund collaboration would also be essential, as Mrs. Ploix had stated.

Mr. Chatah made the following statement:

I am in broad agreement with the staff appraisal, and will, therefore, be brief. First, there is no question that the present fiscal trend is unsustainable, to say the least. The authorities themselves are clearly aware of the critical nature of the fiscal situation which they describe as having reached a crisis point. I agree with the staff that given the already substantial tax burden, efforts should concentrate on containing expenditures. In looking at the factors behind the recent increase in expenditure, it seems that a major reason has been the surge in public sector employment. The pressure to increase government employment when the rate of unemployment is as high as 40 percent is understandable, as mentioned in the staff report. However, this points to the urgent need to develop a comprehensive strategy to boost the country's growth and employment potential, therefore also relieving the public sector of some of its financial burden.

Second, such a comprehensive strategy for boosting output and growth potential has to be export oriented, given the size of the domestic economy and its limited absorptive capacity. It is crucial, however, that export-promoting policies and investment projects be designed in a way which is compatible with the country's limited resource base, its areas of comparative advantage, and its access to foreign markets.

Third, given the underlying long-term nature of Djibouti's problems and development needs, it would seem natural for the World Bank and other development institutions to have a major role in helping Djibouti develop and implement a medium-term comprehensive strategy. In this regard, we have noted the discussions taking place currently to consider the possibility of a study to provide a basis for a long-term development strategy financed under the World Bank's Special Project Preparation Facility for Sub-Saharan Africa. On the other hand, we have also noted that the Bank has kept a relatively low profile in Djibouti and that there are some disagreements between the authorities and the World Bank on certain issues. We hope that these differences will be ironed out soon, thereby also helping to pave the way for fruitful discussions with the Fund in the period ahead on the possibility of a program supported under a structural adjustment arrangement.

Fourth, it is clear that even under the best case scenario, not to mention less favorable ones, Djibouti will continue to need the assistance of the international community, perhaps on an exceptional scale, for some time to come. The expectation must be that such assistance would be forthcoming and adequate to meet Djibouti's needs, particularly when a well-defined and well-thought-out development and medium-term economic strategy is formulated, something which we hope will be taking place in the near future.

Mr. Ouanes made the following statement:

Since 1982, Djibouti's economic and financial situation has steadily deteriorated. Growth turned negative in 1985, and domestic and external imbalances continued to widen. Furthermore, the prospects for 1986 are not encouraging. Economic growth is expected to decelerate, inflation is likely to accelerate sharply, and the fiscal deficit is projected to widen to 8.4 percent of GDP. This deterioration in Djibouti's economic performance has led to a large drawdown in the treasury's deposits despite increased recourse to external financing.

In reversing these trends, Djibouti faces two interrelated challenges. First, from the short-run perspective, it is essential for the authorities to adopt substantial adjustment measures so as to restore financial balance in the economy. In particular, a firmer stance of budgetary policy and a tangible improvement in the operations of the public sector enterprises are needed to help promote a viable external position. In this context, it is important to emphasize expenditure reductions rather than tax revenue increases. As the staff has pointed out, the ratio of tax revenue to GDP already approached 30 percent, much above the average for a country at Djibouti's stage of development. To be effective, the reduction in government expenditure to a more manageable level should be accompanied by a restructuring in current outlays and increased emphasis on the ability of new public investment to generate adequate foreign exchange earnings and fiscal revenue. However, a lasting improvement in the overall fiscal position must include an overhaul of the public sector enterprises. As the staff has emphasized, these enterprises are experiencing serious financial difficulties which have given rise to substantial arrears. In this context, I welcome the recently completed study of public sector enterprises and wonder whether the staff can give us some information about its findings and recommendations.

The second challenge, from a longer-term perspective, is that it is important for Djibouti to implement appropriate structural policies so as to resume sustainable growth. The economic base clearly needs to be widened. While it is true that climatic conditions, the lack of skilled labor, and the narrowness of the domestic market severely constrain large-scale industrial development, it is also true that Djibouti still has untapped potential in a number of areas. In agriculture, despite severe natural resource constraints, there is scope for growth and a significant foreign exchange saving potential. As noted in the staff report, and emphasized in Mr. Mawakani's statement, fruit and vegetable production increased over the past five years, reaching the equivalent of almost 11 percent of imports of those products, and there is scope for a further increase in the current year. There is also scope for increasing the fish catch for local as well as export markets. In my judgment, the intensification of efforts in those directions and in the promotion of labor-intensive, small-scale enterprises producing goods with a high domestic content is essential to support the well-established service sector and resolve the extremely severe unemployment problem.

The success of such a strategy would hinge on the ability of the authorities to create the appropriate environment for promoting the private sector. In this context, the overall investment strategy, and exchange rate and wage policies play an important role. A move, such as the one recommended by the World Bank, from a pure service economy to broader based economic activities would clearly require a reorientation of public investment, a significant improvement in the cost/price structure of the economy, and a more flexible exchange rate policy. Such a policy reorientation should be supported by increased involvement of the World Bank within the framework of the structural adjustment facility. Like Mr. Abdallah and Mrs. Ploix, I sense from the staff report a reluctance on the part of the authorities to adopt adjustment policies within a structural adjustment facility framework, and I would appreciate comments from the staff regarding the reasons for that reluctance.

In conclusion, I commend the authorities on their tighter policy stance and their liberal trade stance, and encourage them to intensify their adjustment efforts toward a broader based and more sustainable growth of the economy.

The staff representative from the African Department observed that as a result of the Fund's close relationship with Djibouti, the staff was proposing, with the agreement of the Djibouti authorities, to move from the 18-month Article IV consultation cycle to a 12-month cycle. The authorities welcomed the Fund's advice and the opportunity afforded by the Article IV consultation to discuss future policies and indeed to take certain recommended and proposed measures. However, as indicated in the staff report, the World Bank and the Djibouti authorities were not in full agreement on many substantial issues. As was indicated more fully in the Bank's latest economic report, the reluctance of the Government of Djibouti to accept the Bank's recommendations was due to the complete change that they would entail in the direction of economic activities since independence in 1977. It was very difficult for a country to shift from a service economy to a generally broader based economic development. As mentioned in the staff report, the areas of potential development about which the authorities were most enthusiastic were those that offered an opportunity for expanding the services sector--namely, the airport, the refurbishing of the railways, and the new telecommunications system, from which the authorities hoped to derive both employment and foreign exchange. The World Bank, on the contrary, would prefer Djibouti to slow down development in the services area, believing that capacity might have expanded more than the potential demand for those activities, and recommending rather that the authorities look more closely at manufacturing, labor-based export processing activities, and agriculture. Thus, interest on the part of the Djibouti authorities in a structural adjustment arrangement was not strong, in particular because of the large divergences of view on fundamental issues between them and the World Bank. Furthermore, the authorities had indicated to the staff that while they had not ruled out possible use of the resources of the structural adjustment facility, they preferred first to observe its operation.

The staff had been informed by the Djibouti representatives that there was scope for an immediate reduction in budgetary outlays in 1986 because parliamentary approval was not required, the staff representative continued. No indications had been received of action in the fiscal area, although the staff had attempted to obtain information from the authorities preceding the Board's discussion of the staff report for the 1986 Article IV consultation.

Likewise, the staff had not been informed of the contents of the recently completed study of public sector enterprises, although it had been available to the authorities at the time of the consultation discussions, the staff representative noted. Therefore, the mission had attempted to visit as many as possible--9 or 10--of Djibouti's 16 public enterprises, enabling the staff at least to discern the seriousness of the situation, for instance, the significant arrears of many enterprises. The authorities had informed the staff that the contents of the review would not reveal any surprises in terms of the magnitude of the problem or the solution. Clearly, as several Directors had mentioned, what was required was a scaling down of investment and more appropriate pricing policies. Despite the probable existence of sufficient capacity in those enterprises to handle foreseeable demand, investment had continued.

In previous Article IV consultations with Djibouti, the staff representative from the African Department concluded, the staff had taken as a given the authorities' firmly held objective of maintaining not only the existing liberal exchange and trade system but also the current rate of DF 177 per U.S. dollar. The staff had suggested that use of the exchange rate as a policy instrument to deal with the fundamental problems of Djibouti, not be precluded. It remained to be seen whether the authorities would seek the staff's advice in that respect in the year ahead.

Mr. Mawakani remarked that it would be difficult for Djibouti to succeed in controlling current expenditure, the largest part of which was on wages and goods and services. There was also insufficient revenue to finance capital expenditure. As he had mentioned in his opening statement, some measures had been taken to increase revenue, including the increase in duty on some imports, higher taxes on automobiles and on audio visual equipment. The authorities were doing whatever they could to correct the imbalances in the economy.

The Acting Chairman made the following summing up:

> Directors were in broad agreement with the appraisal in the staff report for the 1986 Article IV consultation with Djibouti.
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> Directors noted with concern the continued deterioration in Djibouti's economic and financial performance in 1985 and the less than encouraging prospects for the current year. Moreover, looking to the medium term, Directors concurred that given the presently foreseen limited growth in foreign exchange earning potential and also the rising debt service obligations, Djibouti could rapidly confront an unsustainable external position.

Directors commended several policy reorientations that had already been adopted, citing in particular the outward looking and private sector oriented industrial policy and initiatives in the agricultural sector. The authorities' adherence to liberal exchange arrangements and a liberal trade system merited special approval, as did the minimal state interference in commercial activity and the direct regulation of prices.

Nevertheless, further actions were clearly required. Most immediately, there was a need for firmer financial policies, especially budgetary policies, and also for an early start on improving the operations of the public enterprises. Sustained restraint in government spending was called for, and Directors pointed to the wage bill and the high levels of administrative and other outlays as areas that should receive attention. Future capital spending levels would also have to be closely examined, and it was suggested that particular scrutiny be given to both the ability of new investments to generate adequate foreign exchange earnings and fiscal revenues and the recurrent cost implications of new projects. The recent review of the public enterprise sector warranted priority attention, and Directors stressed the need for the implementation of follow-up actions in the near future relating to enterprise cost structures, tariff levels, and capital spending programs. In several of these areas relating to the overall investment program, as well as improving the operations of the public sector enterprises, Directors encouraged the authorities to look to the World Bank for advice and assistance.

In light of the recent sharp increase in Djibouti's external debt and also the rising level of debt service commitments on existing debt, Directors emphasized the need for limiting further debt and thus for a closer monitoring and control of new commitments.

In general, economic and financial restraint would be required, not only to stem immediate pressures on the balance of payments, but also to prevent the erosion of competitiveness for present and possible future foreign exchange earning activities. In this connection, wage restraint was seen as an important element in Djibouti's efforts to improve its competitive position, and Directors also inquired about the possible role that a more active exchange rate policy might play in promoting external competitiveness.

Directors noted that the Djibouti authorities have agreed to the holding of Article IV consultations on the standard 12-month cycle rather than on the 18-month cycle that is presently in effect.

2. BELIZE - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with Belize (SM/86/179, 7/21/86; and Cor. 1, 8/21/86). They also had before them a report on recent economic developments in Belize (SM/86/184, 8/1/86; and Cor. 1, 8/21/86).

Mr. Hodgson made the following statement:

My Belizean authorities appreciate the advice of the staff, and believe that its report provides a reasonable assessment of the current economic situation and prospects for Belize. However, certain aspects of the report require clarification; in particular, one area of importance to the public sector needs to be addressed more fully.

Let me begin by briefly reviewing Belize's performance under its stand-by arrangement. That arrangement, approved in December 1984, was designed to improve the fiscal balance, rebuild external reserves, bring about a strengthening in the overall balance of payments, and eliminate external payments arrears. Early developments under this program were more or less as planned, but the assumptions on external debt amortization payments were not fully realized when it became apparent that some external debt payments could not be rescheduled as projected. In order that the goals of the stand-by arrangement might still be achieved, the Belizean authorities undertook a number of revenue and expenditure measures during the latter part of the program to compensate for one half of the unanticipated amortization payments. The target for the overall deficit of the public sector during FY 1985/86, therefore, was reduced from 5.2 percent of GDP to 4.5 percent. Performance criteria for the end of March 1986 were modified accordingly.

In any event, the actual fiscal outcome for FY 1985/86 was more favorable than planned, largely because of reduced expenditures. All performance criteria for the end of March were met, the current account deficit was reduced to the equivalent of 1.9 percent of GDP (despite a further weakening in world sugar markets), external arrears were eliminated as planned, and reserves more than doubled to the equivalent of 5.7 weeks of imports at the end of 1985. Thus, despite the necessary modifications in midstream, the stand-by arrangement was successfully implemented.

The major issue now facing my authorities is how to overcome the present situation of relative economic stagnation and to place the economy on a sustained growth path. To a great extent, the medium-term growth prospects for Belize will be determined by developments in the external sector. The domestic market itself is small, with low disposable income levels and weak interindustry linkages. In the short term, stronger growth will depend upon increased shrimp farming, expansion of existing citrus, banana and cocoa production, and realization of plans to expand sugarcane output for eventual use as an input for an ethanol project in Jamaica.

Over the longer term, my authorities see the development of tourism, agricultural diversification, and the attraction of foreign investment in manufacturing as areas where export-led growth may be sought. In tourism, an airport development project is currently under way, and hotel capacity already has begun to expand. Diversification in agriculture is proceeding, with assistance from the U.S. Agency for International Development (AID) and the U.K. Economic Cooperation program. Substantial government investment in infrastructural development will be required if private sector investment is to be encouraged and facilitated.

Turning to policy concerns, my authorities would like to emphasize that they remain sensitive to the level and growth rate of public sector expenditure, particularly central government outlays. Efforts are being made at present to monitor spending and revenues much more closely through the involvement of the Central Bank in fiscal forecasting. The staff has expressed concern about the rate of growth of current expenditures, which should, however, be seen in relation to projected growth rates of revenue. In particular, the staff has not taken account of projected collections under the Citizenship Investment Program. While noting the uncertainties which surround this program, my authorities feel that their fiscal projections for FY 1986/87 can still be achieved. The low rate of collections thus far reflects a deliberate effort to assess applications carefully.

The one issue which needs to be discussed more fully is that of public sector staffing. The staff has noted the recent salary increases in the public sector, but has not focused on the existing public sector managerial shortfalls, which have serious implications for the longer-term decision-making capacity of the public service. My authorities would emphasize that there has been a substantial loss of qualified staff to the private sector, and more importantly, to emigration, partly in response to inadequate public sector compensation in recent years. The Government is just beginning to address this issue in a comprehensive manner and substantial restructuring of public sector staff will probably be required if the introduction of a more attractive pay scale is not to result in an unsustainable increase in the wage bill. It is difficult, however, to see how substantial increases in the wage bill for professional staff can be avoided without serious damage to the public sector's management capacity.

My authorities share the staff's concerns about the possible effects of central bank financing of the public sector deficit. It is their view that the impact of increased central bank credit to the public sector would fall most heavily on the international reserves position of the banking system, with only secondary and minor effects on the domestic price level. A loss of reserves would, of course, be most undesirable. However, since my authorities expect to meet their fiscal objectives, they do not anticipate any need to resort to increased central bank financing of the government deficit. Moreover, they would emphasize that, to a substantial extent, banking system financing of the public sector has reflected the desire of the commercial banks to place their excess liquidity with the public sector via purchases of treasury bills plus direct extension of credit. In fact, the Central Bank's holdings of treasury bills currently are substantially below levels normally expected. In sum, central bank financing of the public sector during 1986 may not show any appreciable increase over 1985 levels.

The staff has observed that a sizable interest rate differential in favor of Belize during 1985 may have led to a decline in capital outflows. It is the view of my authorities that in a Caribbean context, financial asset holders have tended to pay greater attention to the safety of their assets in terms of capital values, and to protecting the holdings against the perceived likelihood of adverse exchange rate changes, than to interest rate differentials. The changes in outlook resulting from a change of government in December 1984 could be one factor explaining the stronger capital account position.

It is my authorities' intention to continue to avoid the use of commercial credits, and work has already begun to strengthen the debt monitoring systems within the Central Bank. Steps are also being taken to replace quantitative trade restrictions with a more comprehensive tariff system. As for the exchange rate, it must be emphasized that maintenance of a fixed rate vis-à-vis the U.S. dollar has been an important source of stability, keeping inflation low without necessarily impairing Belize's export capacity. My authorities feel that Belize has been able to sell all that it can profitably produce--if anything, a capacity constraint exists with respect to exports. The impact of any exchange rate realignment, therefore, would fall most heavily upon import costs and imported inflation, while the benefits in terms of increased foreign investor interest in Belize are uncertain and would emerge only slowly.

Finally, my Belizean authorities are fully aware of the sensitivities which surround the medium-term outlook, most notably with respect to international sugar prices and interest rates. This awareness is reflected in their determination to encourage diversification of the Belizean economy and to avoid use of commercial credits.

Mr. Hospedales made the following statement:

In December 1984, faced with rising internal and external imbalances precipitated by a crisis in the international market for sugar--the main export commodity of Belize--the authorities embarked on a comprehensive adjustment program supported by Fund financing. Despite the emergence of a number of adverse factors in the process of implementing the program, leading to its extension by two months, the authorities have succeeded in keeping the program on track by significantly readjusting economic policies. Accordingly, the performance criteria for end-March were all met. This commitment to implementing the adjustment effort has been well appraised not only by the staff--and I am in general agreement with the thrust of its findings and recommendations--but also by Mr. Hodgson in his opening statement.

As a result, the fiscal and external current account adjustment had been impressive, with the overall budget deficit being reduced sharply to 2.5 percent of GDP and the external current account deficit to 1.9 percent of GDP. The underlying rate of inflation continued to fall, although real GDP grew at a slower rate. Commensurately, the net international reserve position has been strengthened, external payment arrears have been eliminated, and the reliance of the public sector on commercial bank borrowing has been reduced. Those results were all commendable. But the staff makes it quite clear that if the progress made so far is to be consolidated, Belize will have to continue to pursue a policy of stringency. It seems to this chair that in the light of the consequences of such stringency for growth and employment, it may not be advisable for Belize to pursue this course at all costs. For this reason, and notwithstanding the existence of several areas of vulnerability, his chair concurred with the Belizean authorities' decision to take advantage of the present international environment to reactivate the economy, especially in the context of a rate of growth of 1.8 percent; in this connection the staff may wish to provide any available information on unemployment in Belize. Belize should be cautious however, and respond appropriately if the international economic environment--in the main, oil, sugar, and citrus prices--should change in a direction that could be considered unfavorable to Belize.

Central to the general economic strategy is a public investment program designed with technical assistance from the World Bank, which is also providing partial funding. The emphasis on improved infrastructure is critical in light of the importance being attached by the authorities to an expansion of economic growth based on investment and export diversification. In this connection, the authorities would be strongly advised to recognize that investment and export-led growth requires continuous strengthening of financial policies and an improved price and cost performance in order to maintain international competitiveness, given the objective of maintaining a fixed exchange rate. Consequently, this chair welcomes the authorities' decision to offset the increase in public expenditure by additional revenue-raising measures, and to reassess expenditure plans in the event that certain specific revenues--namely, the sale of bonds to nonresidents--does not materialize. In any event, the authorities will be well advised in this situation to complete implementation of the 1985 revenue package. Furthermore, in light of the particular approach to growth, and notwithstanding the recent increase in the wages of public sector employees--the first in five years--domestic cost restraint should be accorded high priority. Therefore, an appropriate policy of national pay restraint should be considered a prerequisite to the overall economic strategy since the moderation of wages is a key element in an export-led growth scenario; in that connection, the current procedures for strengthening the operations of public enterprises should be continued.

Belize has been able to attract considerable concessional resources from the international financial community. While this chair does not find that Belize is overindebted--the debt service ratio is approximately 15.2 percent of export of goods and services in 1985--we will caution that, with an outstanding external public debt representing 49 percent of GDP, every effort should be made to ensure that criteria of efficiency are rigidly applied to the use of external resources. Specifically, projects to be funded with external resources should be judiciously selected, be shown to be viable and profitable, and ultimately to be foreign exchange earners--directly through the generation of exports or indirectly through import substitution of critically needed commodities. The rigorous pursuit of an appropriately diversified and productive economic base is central to economic transformation and the maintenance of external creditworthiness.

Finally, this chair notes that the impressive fiscal adjustment has been associated with the narrowing of the current account deficit. It is important to give the highest priority to the mobilization of domestic resources if investment is to continue to rise without having an adverse impact on the current account of the balance of payments. In this respect, we note with satisfaction that national savings are approximately 4 percentage points above the 1982-84 average; every effort should be made to strengthen this ratio. The commitment of the authorities to maintaining positive real interest rates will be a key contributing factor and so will the implementation of the recommendations of a Fund technical assistance mission on tax reform.

Belize has set in train the necessary machinery for establishing the conditions for self-sustained growth and the transformation of the economy. It is crucial that the international financial community continue to provide the appropriate financial assistance required for economic transformation in a developing country like Belize.

Ms. Lundsager made the following statement:

The review of recent developments in Belize is quite timely, following as it does the successful completion of the stand-by arrangement and coming at a time when the authorities appear to be relaxing somewhat their adjustment efforts. While in some respects such relaxation might not appear to be a problem, given that the current account and overall payments positions are expected to be fairly strong this year, there is nonetheless the danger that such complacency could lead to problems in the medium term.

First of all, the authorities deserve recognition for surpassing performance expectations under the stand-by arrangement. The fiscal position turned out much better than expected owing to the supplementary measures adopted under the program. There was a strong improvement in both public and private sector savings; this facilitated the improvement in the payments position, which permitted arrears to be eliminated and reserves to be built up, although a further increase in reserves would be helpful. It is also interesting to note that there may have been a reduction in private capital outflows in response to the improved domestic financial position, including the restrained monetary policy.

These favorable developments are not likely to become a long-run trend, however, because of the somewhat tenuous nature of some of the revenue measures planned for the current year and the resulting likelihood that a cautious monetary policy will be difficult to maintain. It would be advantageous to maintain the deficit at the low level of the past year. While the tax reform is welcome, we would recommend that the emphasis be on expenditure restraint, as opposed to revenue generation, given the rather high ratios of both revenue and expenditure to GDP. Most important from a longer-run perspective, the export duty should be reduced and eliminated as soon as feasible in order to strengthen export incentives over time. In addition, it appears from several comments in the staff report that labor costs are relatively high in Belize and that stronger efforts should be made to contain civil service wages, thereby helping to limit private sector wage increases. We noted Mr. Hodgson's comments on the need to retain managerial staff, a problem that would argue for a selective wage policy as opposed to across-the-board wage increases, such as the July adjustment giving senior personnel a smaller increase than the civil service in general.

To refer in brief to the public enterprises, we welcome the improvements in the sugar sector, which have increased profitability. In the public enterprise sector overall, current operations were in surplus in the past year, indicating that prices appropriately reflected costs. We noticed however that part of the improvement in the operating balance of the Electricity Board was due to delays in expenditures on maintenance, a category of spending that should perhaps be sustained if future capital costs are to be avoided.

Regarding monetary policy, it was not clear to what extent adequate credit would be provided to the private sector, given the uncertain fiscal position. The private sector in Belize probably had some access to foreign borrowing but in light of the overall level of external debt, large increases in private sector debt should be avoided. Thus, care should be taken to provide adequate domestic credit.

Stronger efforts also appear to be needed in order to encourage activity in the productive sectors, including exports. Some changes in the international environment should help, such as the recent depreciation in the effective exchange rate. Nonetheless, the rate has not changed against Belize's major trading partners. Furthermore, the Belize authorities should be keenly aware of the relative competitiveness of their own export sector vis-à-vis those of other countries in the region, particularly in relation to trends in wages.

In conclusion, the authorities made substantial progress under the stand-by program and should consolidate the gains in order to maintain a manageable debt profile. In that regard, the steps taken to improve the monitoring of external debt are quite helpful. The illustrative medium-term outlook, while highly sensitive to assumptions about sugar prices, indicates that financing gaps could emerge, leading to increased reliance on commercial borrowing and debt service difficulties in the next decade. Such an eventuality should be avoided by laying the foundation for a stronger current account position.

Mr. Lankester said that as Mr. Hospedales and Ms. Lundsager had pointed out, the Belizean authorities had achieved considerable progress toward adjustment during the course of the recently expired stand-by arrangement. The outlook for the economy in the short term had been enhanced by the improvement in the terms of trade over the past year or so, as a result of the partial recovery in world sugar prices and the fall in oil prices. He noted that the authorities also hoped to receive considerable revenue from the sale of special bonds that carried the right to acquire Belize passports.

In light of those developments, the authorities seemed to have decided on a significant easing of fiscal policies, Mr. Lankester observed. The projected increase in tax revenue was more than outweighed by an expansion of public spending, which might rise by almost 4 percentage points in relation to GDP in the current financial year compared with the previous year. The budget deficit, before taking into account receipts from the sale of bonds, was set to rise from 3.7 percent of GDP in 1985/86 to 5.3 percent in 1986/87. Whether or not the expansion of the budget deficit would have damaging consequences--most likely in the form of a reduction in reserves--would depend greatly on the likelihood that the projected receipts from the special bond sales would actually materialize. An up-to-date assessment in that respect would be helpful. Even if the projected receipts from bond sales did materialize, it would seem unwise for the authorities to use them to finance current spending. They had stated their readiness to reassess their expenditure plans in the event that the revenue from the bond sales was less than projected. The question was how easy it would be for the authorities to change course in midyear when much of the increase in expenditure had been channeled into higher wages and salaries in the public sector. Although there seemed to have been a good case for increasing civil service salaries in order to persuade qualified staff to remain in the service, it was surely imprudent to use revenue from bonds for the purpose; those salary increases could perhaps have been financed by savings achieved through an increase in the efficiency of the civil service. In any event, it would have been preferable to treat any revenue from the bond sales as windfall gains to be used to add to external reserves or for additional capital spending, as and when the receipts were obtained.

As it was, the authorities would need not only to re-examine their spending priorities if revenue from bonds was less than projected, but they might well also need to reassess the balance between fiscal and monetary policy, Mr. Lankester added. A case could perhaps be made for a rather tighter fiscal policy stance in the year ahead, and for reducing the public sector's recourse to the banking system to permit a faster increase in credit to the private sector. A reassessment of the thrust of domestic policy would also be required if the favorable factors that had improved the external position recently began to change for the worse. The staff's medium-term scenarios emphasized the continuing vulnerability of the external position, at least as long as the real effective exchange rate was kept at the high level that the authorities seemed to favor. For instance, the baseline scenario, which included reasonably optimistic assumptions about the sugar price, showed the emergence of significant external financing gaps in the future. That was a further argument for pursuing a rather cautious policy, and perhaps also for giving greater priority to augmenting reserves.

He appreciated that benefits in terms of confidence and stability had accrued to Belize from the peg of the Belize dollar to the U.S. dollar, Mr. Lankester remarked. At the same time, the country's exports had been damaged to some extent during the period of the sharp appreciation of the U.S. dollar. Belize's competitive position had improved with the subsequent fall in the U.S. dollar but it had still not been restored to what it had been in the late 1970s. As the staff had noted, the present rate might impede progress toward sustained growth and economic diversification, and the authorities would be well advised to keep the exchange rate under close scrutiny.

The fact that Belize continued to maintain an exchange system free from restrictions on current payments and transfers was welcome, Mr. Lankester concluded, as was the process that was under way of replacing import prohibitions and the import licensing system with moderate tariffs. He hoped that the considerable gains made to date under the authorities' cautious policies, particularly under the stand-by arrangement, would not be lightly surrendered.

Mr. Rodríguez noted that despite the need for an extension of the stand-by arrangement and modification of performance criteria, the adjustment program under Belize's stand-by arrangement had in general been completed successfully. The adjustment achieved had even prevented a pronounced downward impact on aggregate demand and investment. In addition, he had been glad to note that the authorities had managed to maintain a reasonable balance between domestic saving and investment as well as a satisfactory average growth rate since 1983 while laying the basis for a sustainable growth path. Maintaining equilibrium between saving and investment was a necessary underlying condition for the pursuit of balanced economic growth and financial stability.

He had mixed feelings about prospects of a sustainable fiscal deficit and external debt situation in the medium term, Mr. Rodríguez added. The economic and financial outlook for Belize was still uncertain, even after the successful completion of an adjustment program supported by the Fund. As the staff had mentioned, the fiscal relaxation planned for the current fiscal year could create a larger than expected fiscal deficit, especially if no further compensatory measures were introduced. Yet from a different perspective, Mr. Hodgson had presented a more promising outlook.

Developments in the external sector should be closely monitored, Mr. Rodríguez considered, in order to avoid a worsening of external debt and debt service, especially given the sensitivity of revenue to sugar exports, the major export item.

The staff representative from the Western Hemisphere Department said that it was difficult to make a good assessment of the likely revenue to be derived from the sale of the special bonds that the authorities were counting upon to meet the financing needs of the current fiscal year. The most recent information available from the authorities was that a few of the bonds had been sold and a number of applications to buy the bonds were being considered. As noted in the staff report, great uncertainty existed regarding the bond sale; moreover, revenues generated through the bond scheme were unlikely to be permanent, requiring the authorities to look for alternative sources of revenue in future years or to change their expenditure policies.

The only available information on unemployment was contained in the recent economic developments paper, the staff representative from the Western Hemisphere Department stated. The official rate of unemployment had been in the neighborhood of 14 percent prior to 1985, and had been 15 percent in 1985. At the same time, those figures might be misleading because there was apparently a demand for labor in the agricultural sector in Belize. Indeed, there had been some immigration into Belize to meet that demand.

Mr. Hodgson observed that Directors had rightly focused on the fiscal position as the greatest cause for concern. Understandably, they had doubts about the future of the bond sales, especially as there was no prospect of continued revenue from those sales. It should be noted that the possibility existed of a modification to the bond sales program later in the fiscal year if it became clear that revenue was insufficient. Certainly, the authorities were determined to make every effort to meet their fiscal target.

As a first step in that direction, Mr. Hodgson added, the authorities were studying the recommendations of the Fiscal Affairs Department. Their preference was to concentrate on improving the administration of existing tax legislation. It would be recalled that a number of changes had been made to a wide variety of taxes toward the end of the period covered by the stand-by arrangement, not all of which had had the expected results. Therefore, the authorities would concentrate their efforts on fully implementing those changes while at the same time undertaking a broader review of the tax system.

While the Belizean authorities continued to believe that maintaining the peg of the Belize dollar to the U.S. dollar provided an element of stability to the economy, the appropriateness of the rate was monitored carefully, Mr. Hodgson concluded. Attention was also paid to exchange rate developments elsewhere in the Caribbean region.

The Acting Chairman made the following summing up:

> There was broad agreement with the views expressed in the appraisal in the staff report for the 1986 Article IV consultation with Belize. Directors observed that the economic program of the Government for FY 1985/86 had achieved the objectives of strengthening the net international reserve position of the country, had worked to eliminate external payments arrears, and had lowered the reliance of the public sector on external financing on commercial terms. Directors commended the authorities for their efforts in the fiscal area in FY 1985/86, which had resulted in a lower public sector deficit than envisaged, and for the tightening in monetary policy that helped to achieve a turnaround in the balance of payments.

At the same time, Directors expressed concern about the outlook for fiscal policy. Questions were raised about whether the sale of special bonds to nonresidents would produce the resources envisioned, and indeed about whether it would be appropriate to use revenues generated by the sale of these bonds to offset increases in expenditures. In addition, Directors were concerned about the deterioration in public sector savings resulting from the sharp increase in current government expenditures envisioned for FY 1986/87. Directors encouraged the authorities to develop fiscal measures to eliminate the risk of a serious weakening of the public finances, and also to continue to improve their monitoring of the operations of the public enterprises.

Directors noted the positive response of time and savings deposits in the banking system to the increase in interest rates on deposits. It was felt that there might be room to accommodate a greater part of the credit demand of the private sector, provided that credit to the public sector was kept under control.

Directors noted the importance of maintaining, and indeed improving, Belize's external competitive position and for diversifying Belize's export structure. In that respect they noted that the real effective exchange rate of the Belize dollar is still above its 1980 level even after the recent depreciation of the U.S. dollar against other major currencies. Questions were raised regarding the appropriateness of the present exchange rate arrangement in light of the medium-term prospects of the balance of payments. The authorities were urged to keep the exchange rate under close review, taking into account developments in Belize's competitiveness and in the balance of payments.

The elimination of delays in payments and the maintenance of an exchange rate system free of restrictions were welcomed.

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

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/86/138 (8/27/86) and EBM/86/139 (8/27/86).

3. HAITI - TECHNICAL ASSISTANCE

In response to a request from the Haitian authorities for technical assistance in the fiscal field, the Executive Board approves the proposal set forth in EBD/86/233 (8/21/86).

Adopted August 27, 1986

APPROVED: May 4, 1987

LEO VAN HOUTVEN
Secretary