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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/17

10:00 a.m., February 4, 1985

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	A. K. Diaby, Temporary
C. H. Dallara	M. K. Bush
	G. Ercel, Temporary
	G. E. L. Nguyen, Temporary
	N. Haque, Temporary
H. Fujino	M. Sugita
G. Grosche	
J. E. Ismael	
R. K. Joyce	G. D. Hodgson, Temporary
A. Kafka	
	A. Lindø
	A. Abdallah
	M. A. Weitz, Temporary
	E. M. Ainley, Temporary
	G. Ortiz
	A. Steinberg, Temporary
	A. V. Romuáldez
	O. Kabbaj
	A. S. Jayawardena
N. Wicks	T. A. Clark
	N. Coumbis
Zhang Z.	

L. Van Houtven, Secretary
S. J. Fennell, Assistant

Also Present

S. Yusuf, IBRD. Asian Department: K. A. Al-Eyd, J. H. Felman, K. Saito, D. A. Scott, S. Takagi. European Department: P. Dhonte. Exchange and Trade Relations Department: M. Guitián, Deputy Director; E. H. Brau, K. Flug. Fiscal Affairs Department: J.-F. Garnier. IMF Institute: M. A. Dessart; I. P. Leilua, Participant. Legal Department: A. O. Liuksila, J. M. Ogoola. Middle Eastern Department: M. A. El-Erian. Secretary's Department: J. W. Lang, Jr., Deputy Secretary. Western Hemisphere Department: S. T. Beza, Associate Director; L. E. DeMilner, Z. Hodjera, J. P. Pujol. Advisors to Executive Directors: H. A. Arias, H.-S. Lee, G. W. K. Pickering, A. Vasudevan. Assistants to Executive Directors: J. R. N. Almeida, I. Angeloni, W.-R. Bengs, J. Bulloch, V. Govindarajan, Z. b. Ismail, K. Murakami, E. Olsen, W. K. Parmena, J. Reddy, D. J. Robinson, J. E. Rodríguez, A. A. Scholten, E. L. Walker, B. D. White.

1. REPORT BY DEPUTY MANAGING DIRECTOR

The Deputy Managing Director, commenting on his recent visit to Southeast Asia, said that he had spoken at the joint IMF/SEACEN Annual Seminar held at the South-East Asian Central Banks' Research and Training Centre in Kuala Lumpur. In the past, the Fund had provided technical assistance to the center, which had been established to facilitate collaborative efforts on research and training among central banks and monetary authorities. He had also attended the 20th Conference of the Governors of the Southeast Asian Central Bank Association. In addition, he had met with the Prime Minister of Malaysia and other government officials, and had addressed the Association of Commercial Banks in Malaysia. Likewise, in Singapore, he had given a short talk to the Association of Commercial Banks and had spent one day visiting officials in Indonesia.

The main themes touched upon in the seminar and at the SEACEN Governors' Conference had focused on the efforts and progress made to date in dealing with the international debt problem, the Deputy Managing Director indicated. There had also been considerable interest in the outlook for 1985, particularly with respect to exchange rate developments, world economic growth commodity prices and inflation. He had discussed in some detail possible developments within the medium-term framework of the staff papers on the 1985 World Economic Outlook and had examined the key assumptions that would have to be met if debt problems were to continue to be resolved. Participants in the meetings had also been concerned about the prospects for avoiding inflation in future and the consequences of deflation, especially the effects of a decline in interest rates and its impact on the solvency of financial institutions.

A great deal of concern had been expressed about the impact of protectionism not only on the export volume of countries in the region but also indirectly on the pattern of investment flows, the Deputy Managing Director commented. Many of the countries in the region had adopted a relatively open policy to attract foreign direct investment, but investors preferred to shelter behind the trade barriers set up by other countries, thereby creating fears that protectionism was distorting the flow of direct investment.

He had had an opportunity to discuss the Fund's role in providing technical assistance, both at the SEACEN Governors' Conference and with government officials in Malaysia and Indonesia, the Deputy Managing Director noted. The Fund's technical assistance, including the contribution of the resident representative, was helping the Government of Indonesia to develop financial markets and had also played an important role in Malaysia and in other countries in the region.

Vice Minister Lee Hoang of the State Bank of Viet Nam had asked for a meeting with him, the Deputy Managing Director remarked, to discuss Viet Nam's overdue obligations to the Fund. The Vice Minister had emphasized that it remained the policy of Viet Nam to settle its overdue obligations and to maintain normal relations with the Fund. He had pointed out, however, that difficult circumstances--including the typhoon in 1984--had made it impossible for the authorities to discharge those obligations. The authorities would explain the country's special difficulties in detail during the forthcoming Article IV consultation mission in March 1985, when they would take up the question of rescheduling their payment arrears. They intended to pay overdue charges as soon as they had mobilized the necessary funds, and, for that purpose, they were attempting to negotiate a short-term loan of $6 million with a commercial bank. While he welcomed their wish to maintain normal relations with the Fund, he had pointed out that under the Fund's policy of uniform treatment of members, Viet Nam would be required not only to pay overdue charges but also to discharge its overdue repurchase obligations, as it was against Fund policy to reschedule repurchase obligations. He had informed the authorities that the Executive Board and the management considered that Viet Nam had made insufficient efforts to remain current in payments to the Fund. The Vice Minister had reiterated that the special circumstances beyond Viet Nam's control would be explained when the staff visited the country in March.

2. WESTERN SAMOA - 1984 ARTICLE IV CONSULTATION AND REVIEW UNDER STAND-BY ARRANGEMENT

Executive Directors considered the staff report for the 1984 Article IV consultation with Western Samoa and a review of its stand-by arrangement (EBS/85/4, 1/7/85; and Sup. 1, 1/31/85). They also had before them a report on recent economic developments in Western Samoa (SM/85/18, 1/18/85).

Mr. Romuáldez made the following statement:

> Western Samoa is no stranger to adjustment. Environmental shifts, whether political or economic or even natural, have served only to confirm the people of Western Samoa in their determination to come to terms with the adjustment process and use it to full advantage. Indeed, from its origins in myth when, it is said, Lu, one of the deities of the Samoan pantheon, fled into exile from the wrath of Tagaloalagi (the "life source") and adapted to the exigencies of earthly life by cultivating sacred hens (sa moa) on an island in the South Pacific, to its earliest days of independence in 1962, resilience in the face of changing circumstances has been a hallmark of the Samoan character. So has it been under this Fund arrangement in 1984.
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> Western Samoa has performed well under the current stand-by arrangement, which is subject to a midterm review within the context of the 1984 Article IV consultation. All performance criteria through December 1984 have been met, in most cases comfortably. Central to this performance have been cautious financial policies, as reflected in the containment of the central government deficit in 1984 to the equivalent of only

2.5 percent of GDP, as against the program target of 2.9 percent of GDP. This fiscal restraint facilitated in 1984 a reduction of nearly 18 percent in net credit of the banking system to the public sector and allowed relatively strong growth in lending to the private sector (about 20 percent) to occur without causing the overall net domestic assets ceiling to be breached.

Other policy measures implemented in 1984 included reform of import duties and excises to provide a more uniform rate of protection and to strengthen the tax base, devaluation of the tala (by about 12 percent in both nominal effective and real effective terms in the nine months to September), the dismantling of the foreign exchange allocation system and more effective administration of the lending activities of two government lending organizations. With the establishment of the Central Bank in May 1984, the implementation of monetary policy has also been considerably strengthened.

Just as the policy measures implemented within the framework of the current arrangement have consolidated progress made under the successfully completed 1983 program, the authorities intend to maintain their adjustment efforts in the year ahead and to promote private sector activity with greater vigor. Notably, the Government budget for 1985 allows for a deficit equivalent to only 1 percent of GDP (although this could increase if additional concessional external finance is forthcoming), and, perhaps more importantly, budgeted expenditure as a percentage of GDP (after making allowance for the removal of the Government's exemption from import duty in 1984) will be held to around the reduced levels achieved in 1982 and 1983, or some 10 percentage points below the percentage in 1981. They are moving, moreover, toward further streamlining the operations of public sector enterprises. It is expected that inflation will be reduced beyond the program's original target to 8 percent. The authorities also intend to continue to pursue interest rate and exchange rate policies which support the medium-term adjustment effort, although here it is to be noted that interest rates are already substantially positive in real terms, and that the real effective exchange rate during 1984 reached its lowest level since early 1980.

The management of the country's external debt continues to pose a special challenge to the authorities. They have nevertheless progressed toward exercising meaningful control over it: they have, within a short time, succeeded in eliminating commercial arrears and are in process of coming to some settlement on remaining official debt arrears; they have trimmed down their development program to proportions consistent with their absorptive capacity and have consequently reduced external borrowing requirements to levels in line with available concessional finance. Given continued import restraint, Western Samoa's external debt ought to become increasingly manageable. It is expected that the debt service ratio should decline from 42 percent (or 22 percent, with private remittances included in the denominator) in 1985 to 20 percent (or 11 percent) in 1989.

In all, the adjustment effort which Western Samoa has undertaken has been substantial. Nonetheless, the Western Samoan economy, and in particular its balance of payments, remains structurally weak and vulnerable to adverse external developments. This is reflected in the objectives of the current program--2 percent real growth, an external current account deficit equivalent to 12 percent of GDP and an average annual inflation rate of 12 percent--which must be considered as modest against the strength of the adjustment effort which the program has called for.

The challenge facing Western Samoa, therefore, now that short-term macrostability and balance of payments viability have been largely restored, is to strengthen the production sectors. Indeed, progress is already being made, on a general plane, through such measures as the dismantling of the foreign exchange allocation system, and more directly through, for instance, the suspensory loan scheme designed to encourage cocoa planting and the coconut tree replanting program. The forestry and timber industries, production of tropical fruits, and some light manufacturing are other areas of activity which have been developed with success. In further developing this thrust toward strengthening existing activities and developing new industries to provide a degree of diversification, Western Samoa will clearly need assistance--both technical and financial. In both respects there may be scope for the World Bank to play a greater role than in recent years. Meanwhile, the authorities are keen to maintain a close ongoing relationship with the Fund. It goes without saying that they, and we, greatly appreciate and value the efforts that the staff have made in assisting Western Samoa overcome its economic difficulties. The authorities are especially grateful for the additional assistance which the Fund has recently agreed to provide by stationing a resident representative in Apia.

Let me conclude then by saying that the authorities broadly agree with the staff appraisal and believe that the performance criteria and indicative targets proposed for the remainder of the current stand-by arrangement are appropriate, and, indeed, consistent with their own objectives.

Mr. Ismael commended the authorities for successfully implementing the adjustment program. Economic performance had improved; aggregate demand had been effectively controlled, and the supply of domestically produced goods had increased. Real GDP had grown in 1984, the rate of inflation had been reduced substantially, and the external current account deficit had been narrowed.

The objectives for 1985--a real GDP growth of 2 percent, an inflation rate of 8 percent, and a current account deficit equivalent to 13 percent of GDP--could be achieved if the present adjustment efforts were sustained, Mr. Ismael considered. He was concerned, however, about developments following the completion of the current stand-by arrangement in mid-1985. He hoped that a new arrangement with the Fund to consolidate the improvements achieved thus far could be agreed upon. Could the staff indicate the authorities' intentions in that respect?

The reduction in the fiscal deficit to more manageable levels was commendable and reflected primarily an increase in revenues from 26 percent of GDP in 1983 to a record level of 31 percent of GDP in 1984, Mr. Ismael observed. Further improvements would be difficult as the revenue ratio in Western Samoa was extremely high by international standards. Revenues could, in fact, decline if there was an adverse development in the terms of trade, and he therefore urged the authorities to pay greater attention to expenditure control as a means of improving fiscal performance. The authorities' decision to limit public sector wage increases to 5 percent and to freeze the size of the civil service was welcome. On a related point, the reduction in the overall deficit of the state enterprises from 8.5 percent of GDP in 1981 to 2 percent of GDP in 1984 was commendable, but he urged the authorities to monitor developments in that area closely as the situation could deteriorate sharply with only a modest deterioration in the terms of trade.

Interest rates--established when inflation had been running at an annual rate of 16.5 percent--were too high and might have been discouraging business investment, Mr. Ismael considered. Some reduction in interest rates might be justified as the rate of inflation had been brought down to 12 percent in 1984 and was expected to decline further to 8 percent in 1985. The staff did not support that view, arguing that even at current rates of interest, credit expansion to the private sector was too high. However, the rapid domestic credit expansion to the private sector might ease for a number of reasons. First, a substantial proportion of credit was devoted to trade financing, and the depreciation of the tala and the high inflation rate were requiring businesses to hold larger working balances at present, a factor that might not be relevant in the coming period. Second, foreign trade credit had been diverted from overseas suppliers to domestic commercial banks. Third, as the public sector was pre-empting two thirds of total bank credit, it was not surprising that there was such intense competition for bank credit from the private sector. There was scope for increasing the share of total bank credit that was directed to the private sector, reducing the rate of interest charged by commercial banks, and narrowing the gap between the interest rates charged by commercial banks and those charged by the National Provident Fund and the Development Bank. He would appreciate the staff's view on that subject.

The balance of payments improvements were welcome, but as net foreign assets remained negative the authorities should continue pursuing appropriate adjustment policies, Mr. Ismael stated. They intended to avoid commercial borrowing as part of a broader strategy to gradually reduce the debt service ratio to more sustainable levels. Finally, he supported the proposed decisions.

Mr. Fujino noted that after three years of negative GDP growth in 1980-82, economic adjustment had been successfully initiated under the 1983 stand-by arrangement. He commended the authorities for continuing their adjustment efforts under the 1984 stand-by arrangement: economic performance had been strengthened, the rate of inflation lowered, and the external current account deficit reduced.

In view of the remaining structural weaknesses in the economy, however, the commitment to cautious financial policies and efforts to strengthen the productive sectors should be maintained in 1985, Mr. Fujino remarked. Real economic growth could be sustained, and the external position improved over the medium term, assuming the continuing pursuit of cautious financial policies and a strengthening of the productive sectors.

The reduction of the budget deficit to 11.9 percent of GDP in 1985 was crucial for containing domestic credit and liquidity, Mr. Fujino commented. That reduction would come largely from the expenditure side; the authorities aimed to limit wage increases for public sector employees to 5 percent, and development expenditure was expected to decline in real terms as a result of the scaling down of the development program and increased utilization of private contractors to reduce cost overruns. Care should be taken to ensure that future economic growth was not jeopardized by a less ambitious development program. About one half of the projected 15 percent increase in domestic revenues would come from higher nontax revenues, including higher user charges on utilities. The tax measures to be introduced in 1985 could have a mixed impact on the economy and should be reviewed as part of the rationalization and broadening of the income tax system. He would be interested to hear the staff's comment on recent developments and prospects in that area. The authorities' plans to improve the profitability of the public enterprises, while welcome, should be strengthened.

The growth of net domestic assets would be limited to about 5 percent in 1985, Mr. Fujino noted. Although net credit to the public sector was expected to decline further, credit to the private sector might be allowed to rise by 18 percent, less than the estimated 20 percent increase in 1984. The projected credit expansion would be in line with stabilization objectives, while providing enough support for increased economic activity in the private sector, as envisaged in the program. The authorities had recently improved control over credit flows. They should manage their credit program cautiously in spite of the need for faster credit growth to the private sector arising from the recent changes in the financial system.

Interest rates had become increasingly positive in real terms because of the declining rate of inflation, Mr. Fujino noted. In any adjustment program the move toward positive real interest rates should be gradual, as interest rate policy was an integral part of external adjustment.

Exchange rate adjustments in the past two years, together with higher taxes on imports and tighter credit policies, had begun to promote import substitution and were expected to stimulate export production, Mr. Fujino remarked. However, given the continuing weakness of the current account, exchange rate policy should continue to be used actively in the medium term. In view of the high debt service ratio, estimated at about 61 percent of exports of goods and services in 1984, efforts should be made to reduce external borrowing. He assumed that the staff was endorsing the promotion of import substitution by means of a tariff increase on daily necessities in an effort to ensure effective use of resources that were not being productively employed at present. However, in the long term, the promotion of import substitution in a small island economy might not be conducive to efficient use and allocation of limited resources. Finally, he supported the proposed decisions.

Mr. Hodgson congratulated the authorities for the comprehensive manner in which they had implemented the stand-by arrangement. All performance criteria for September and December 1984 had been met, and nearly all of the program targets had been reached. Those achievements were all the more impressive given the effect of the 1982-83 drought on agricultural production. The positive results achieved by the authorities since 1983 indicated clearly that the pursuit of appropriate policies could lead to economic stability in small open economies.

The authorities' implementation of a tighter fiscal policy, increased control over credit, and adherence to a flexible exchange rate policy had produced positive results under the 1984 stand-by arrangement, Mr. Hodgson observed. The program targets for inflation, economic growth, and the balance of payments position had been largely met. Although nominal interest rates had remained unchanged, real interest rates had become positive because of the decline in inflation. The authorities had taken steps to reduce the external payments arrears and had remained within the program ceilings for external loans, including rescheduling.

A few shortcomings in economic performance had been evident in 1984, however, Mr. Hodgson noted. While he welcomed the greater than targeted reduction in the overall fiscal deficit and the impressive steps taken to increase revenues, the overrun in capital expenditure was disappointing and should be dealt with. Moreover, the performance of the public enterprises had been variable. The lending practices of the Development Bank and the Provident Fund should be strengthened. In view of those shortcomings, the authorities' recognition of the need to sustain the adjustment effort in 1985 was welcome. Their emphasis on the promotion of the private sector was commendable given the importance of increasing that sector's share of economic activity. Nevertheless, the best way to increase credit to the private sector was to reduce the public sector's demand for credit by strengthening its financial position. Such a step would help to impose some added financial discipline on the parastatals.

The programmed reduction in the budget deficit was appropriate and consistent with a stronger role for the private sector, Mr. Hodgson considered. The planned revenue measures, particularly the rationalization of the tariff structure, were appropriate. He welcomed the measures to contain both current and capital expenditure, including the use of private contractors in completing the airport extension. He was concerned about the pace of adjustment in the public enterprises; this overall deficit was expected to grow by almost 0.5 percent of GDP in 1985. Could the World Bank play a role in the restructuring of that sector?

The authorities' desire to reduce the spread in commercial bank interest rates was an effective way to allocate more credit to investment than to consumption, Mr. Hodgson remarked. While interest rates should not be lowered too rapidly, there was room for change in the rate structure without making interest rates negative in real terms. The establishment of a central bank had also been a useful step toward strengthening the role of monetary policy.

The authorities' commitment to a flexible exchange rate policy was to be congratulated, but he urged them to follow that policy closely as the balance of payments position was still weak, Mr. Hodgson stated. He welcomed their prudent approach toward external borrowing.

The medium-term outlook gave reason for optimism, but the adjustment process must be continued if positive results were to be achieved, Mr. Hodgson considered. Diversification of the economy was necessary not only to strengthen the productive sectors but also to reduce the impact of any external shocks. He would appreciate further comment from the staff on the employment situation in Western Samoa. The authorities had demonstrated how a small island economy could help itself, even in the face of variable climatic and economic conditions. He hoped that the positive results could be sustained and strengthened. Finally, he supported the proposed decisions.

Mr. Ainley indicated his support for the proposed decisions. Western Samoa's economic progress in the past two years had been substantial, and the authorities remained committed to continuing economic adjustment in 1985. The contrast between the country's economic position at present and in the early 1980s was striking. As a result of two successful Fund-supported stabilization programs, growth had recovered, the rate of inflation had been halved, the overall balance of payments was in surplus, and arrears had been reduced. A sound base existed for sustained growth in the future. All was not perfect, however; the economy remained structurally weak, vulnerable to external developments, and highly dependent on concessional flows. The authorities recognized the urgency of consolidating the recent gains and pursuing policies aimed at diversifying and expanding the productive base.

The doubling of revenues in the past two years was impressive, Mr. Ainley considered. While the present comprehensive review of the tax system should lead to further improvements, strict control should also be maintained over expenditure, which had risen faster than expected in 1984. The firm policy on public sector wages and employment should be particularly helpful in that regard. The public enterprises remained a source of weakness, and their activities would be transferred to the private sector as planned in order to strengthen the overall fiscal position.

The authorities had to strike a difficult balance between the two objectives of reducing the rate of inflation further and encouraging growth in the private sector, Mr. Ainley observed. He shared their concern that the high level of interest rates might be discouraging productive investment by small businesses, thereby damaging the prospects for future growth. There was scope for gradual reductions in interest rates in line with progress on the inflation front. More generally, he welcomed the improvement in monetary control following the recent establishment of a central bank. In particular, the lending activities of the Development Bank and the Provident Fund had been brought under closer supervision, an important step toward ensuring the productive use of available resources.

The recent devaluation of the tala, supported by firm domestic policies, had encouraged import substitution and strengthened the balance of payments, Mr. Ainley noted. Western Samoa's experience indicated that a judicious exchange rate strategy could be an effective tool for structural adjustment. He welcomed the authorities' commitment to a flexible exchange rate policy.

In the medium term, sound financial policies would have to be accompanied by appropriate incentives to revive traditional export crops and strengthen the productive sectors, Mr. Ainley considered. The authorities' recent action to bring their development strategy nearer in line with the country's absorptive capacity and with a manageable debt service ratio was appropriate. The World Bank should play a greater role in Western Samoa, even though it was already involved in the agricultural sector. In sum, the medium-term outlook seemed favorable assuming that the authorities continued to pursue prudent policies.

Mr. Grosche observed that sustained Fund-supported adjustment had improved the Western Samoan economy substantially and demonstrated that determined implementation of stabilization measures could restore the basis for a resumption of real economic growth. The authorities should be commended for achieving most of the program targets and for meeting all the performance criteria through December 1984. Developments had, however, been less satisfactory in some areas, particularly with respect to government expenditure, the performance of public enterprises, and total liquidity growth. The generally favorable outlook for 1985 should not detract from the need to continue stabilization efforts even after the expiration of the current stand-by arrangement. The authorities should consider reducing the country's dependence on Fund financing, having made prolonged use of Fund resources, including five stand-by arrangements and one drawing under the compensatory financing facility. Continued effective demand management, successful efforts to strengthen the productive sector of the economy, and an appropriate exchange policy were prerequisites for the achievement of a sustainable position in the medium term.

He generally endorsed the thrust of economic policies envisaged for 1985, Mr. Grosche remarked. Nonetheless, he wondered if more efforts could be made to improve the performance of the public enterprises so that more credit could be directed toward the private sector. The credit program should be managed cautiously, and he welcomed the recent improvement of supervision over the lending of two key nonbank financial institutions whose credit activities had slipped out of the authorities' control.

The active use of exchange rate policy had contributed to the achievement of the adjustment goals by reducing import demand and increasing the incentives for import substitution and exports, Mr. Grosche noted. The present exchange rate seemed appropriate, but exchange rate policy should be used actively over the medium term to sustain the adjustment process. In conclusion, he supported the proposed decision.

Mr. Dallara observed that the authorities had consolidated the gains made during the 1983 adjustment effort. In particular, all performance criteria and most of the program targets of the stand-by arrangements had thus far been met; real GDP had grown by approximately 2 percent, the inflation rate had been reduced to 12 percent, and the government budget deficit had been narrowed to 2.5 percent of GDP, including a cap on increases in public sector employment.

The larger than expected reduction in payments arrears, the growth in gross international reserves to the equivalent of more than two months of imports, and the dismantling of the foreign exchange allocation system were commendable, Mr. Dallara stated. The authorities should continue implementing supporting policies to restrain demand, as the somewhat unusual relationship between the total level of imports and the total level of exports in Western Samoa suggested that excessive demand would translate into a rapid deterioration in the external position. The pursuit of a flexible exchange rate policy should be continued.

The current account had been reduced to 12 percent of GDP, and the overall balance of payments position had exceeded expectations, with a surplus of almost SDR 6 million, Mr. Dallara noted. Yet, in some respects, the improved external position might be viewed as tenuous. A reduction in the international prices of some of Western Samoa's commodity exports could have a sharp impact on the country's external position, particularly if production did not increase correspondingly. That the level of gross reserves in terms of imports was expected to remain roughly constant in the medium term was of some concern given the sensitivity of Western Samoa to the prices of its key exports. It would be useful if Mr. Romuâldez could indicate the authorities' intentions regarding reserves.

The budget for 1985 was based on the assumption that commodity prices would remain steady and that agricultural production would remain static or even decline, Mr. Dallara noted. To reverse that decline and promote exports, the authorities must increase privatization and structural reform efforts in the agricultural sector. Could the staff indicate the involvement of the Asian Development Bank or the World Bank in Western Samoa's agricultural sector? How important were improvements in that area to the overall success of the country's adjustment efforts?

The 1985 budget was in line with the authorities' emphasis on the private sector, Mr. Dallara considered. In particular, the spending reductions would increase the availability of credit to the private sector. Enhancing the financial position of the public enterprises through reorganization and a transfer of some functions to the private sector was appropriate. The authorities' efforts to manage the credit program carefully, including continued monitoring of the lending operations of nonfinancial institutions and the pursuit of a cautious interest rate policy were essential to maintaining a low rate of inflation and demand while expanding activity in the private sector.

External borrowing requirements should be kept in line with concessional resources, Mr. Dallara commented. The authorities should reduce their dependence on the inflow of foreign grants, perhaps by developing the agricultural sector.

He commended the authorities for their determination in implementing difficult adjustment measures and for successfully completing the 1983 Fund-supported adjustment program, Mr. Dallara stated. Western Samoa had, however, adopted a number of stand-by arrangements in recent years; at the conclusion of the current program, outstanding use of Fund credit would amount to 149 percent of quota. Continued progress by Western Samoa was necessary to reduce its dependence on Fund financing. Allowing for repayment of remaining arrears, repurchases from the Fund, and a modest increase in reserves, the overall balance of payments was estimated to register a small surplus through 1989. Could the staff or Mr. Romuâldez comment on the likelihood that Western Samoa would have achieved a sustainable payments position by about 1987. In conclusion, he supported the proposed decisions.

Mr. Clark commended the authorities for their adjustment effort but noted that the medium-term outlook was such that they would need to sustain that effort. In particular, the authorities should pursue their reform of the parastatals, in which World Bank involvement was essential, and ensure that exchange rate policy served to strengthen the structure of the external accounts. Export volume had fallen by 15 percent in 1984 rather than rising by 6 percent as projected. The staff had attributed that fall to the lagged effects of the 1982/83 drought, and he wondered whether those effects had been in evidence when the program had been negotiated in early 1984. Why had the projected recovery in export volume been slow? Finally, he supported the proposed decisions.

The staff representative from the Asian Department, responding to Directors' questions on credit policy, stated that while the authorities recognized the need for some interest rate adjustment, they had so far considered that course of action inappropriate given the strong demand for credit from the private sector and the need to generate greater savings through bank deposits. The staff had urged the authorities to be cautious in reducing interest rates in view of the recent rise in the rate of inflation, but it agreed that the share of credit to the private sector should be gradually increased.

The authorities had recently reformed import duties and excise taxes and were currently reviewing the income tax system with a view to revising the system in 1986 or 1987, the staff representative indicated. The authorities aimed to rationalize and broaden the tax base, particularly in the agricultural sector, perhaps through some kind of export tax on selected commodities, and to improve tax collection and administration. They were revising the income tax code with Fund technical assistance. As fiscal year 1985/86 was between the two years of major tax reform, the revenue contribution to the budget from tax measures was expected to be relatively small.

The medium-term scenario presented in the staff paper was based on the policy adjustments required to achieve the authorities' objectives on major economic variables, the staff representative remarked. The staff had assumed that efforts to restrain demand and strengthen the production sector would be maintained, particularly that a flexible exchange rate policy would be pursued and that specific measures would be introduced in the traditional production sectors.

The authorities considered that Western Samoa should have a relatively high level of reserves, equivalent to at least three months of imports, the staff representative indicated. Although in the recent past the authorities had been unable to achieve that objective because of arrears and other liabilities, they intended to make progress toward their goal in 1985.

No data on the unemployment situation in Western Samoa was available, the staff representative stated. The problem was really one of under-employment, rather than unemployment, as individuals who lost their jobs in the cities would return to work on the family farm. The unemployment situation was not critical at present. In the past, high unemployment had been followed by an increase in emigration, and there was no sign of increased emigration at present.

The World Bank had increased its involvement in Western Samoa, the staff representative commented. A Bank staff member had participated in the Fund's mission to Apia for the Article IV consultation and review of the stand-by arrangement. The World Bank was currently finalizing arrangements on a cofinancing loan with the Asian Development Bank (AsDB) for Western Samoa amounting to $6 million. Other cofinancing loans were being reviewed by the staff of those two institutions. The authorities were reviewing a recent study of the agricultural sector by the AsDB with the aim of developing a new agricultural strategy. The AsDB was considering providing additional financial assistance when the review was complete.

The authorities had informally expressed their interest in the possibility of a follow-on stand-by arrangement, the staff representative from the Asian Department indicated. However, the staff had not received any communication from the authorities on that matter since the Article IV consultation discussions.

Mr. Romuâldez remarked that the authorities would continue to cooperate closely with the Fund and were seriously considering requesting a follow-on stand-by arrangement. They had found it easier to implement adjustment efforts with Fund support given the political environment.

The Acting Chairman made the following summing up:

Executive Directors warmly commended the Western Samoan authorities on the economic performance in 1984. Output growth had been sustained, inflation had slowed, and the external current account deficit had declined slightly, owing in part to more favorable terms of trade developments. It was also noted that gross international reserves had risen considerably and that external commercial arrears had been eliminated.

Directors attributed much of the economic improvement to the authorities' policies, especially the efforts made to expand domestic output and restrain underlying government demand. They commended the authorities for the successful implementation of a series of exchange rate adjustments, the tariff reform, and the liberalization of the import system.

Directors noted that the Government continued to follow cautious financial policies. The overall budget deficit was limited to the equivalent of some 2.5 percent of GDP, and the government revenue performance was commended by Directors. It was noted that, with the decline in government borrowing from domestic banks, the expansion of total domestic credit and liquidity growth had been kept under control.

Directors noted that progress made in economic stabilization had improved growth prospects, but they stressed the importance of maintaining cautious demand management and flexible exchange rate policies and of continued structural improvements in the economy in order to ensure sustained economic growth over time. The macroeconomic targets for 1985 of a 2 percent growth in real GDP, lowering inflation to 8 percent, and containing the current account deficit to 13 percent of GDP were considered feasible by Directors.

Directors supported fiscal policy for 1985, as it aimed at further reducing the overall budget deficit largely through wage restraint, limiting the hiring of new government employees, as well as other expenditure restraint. On the revenue side, Directors noted that the authorities would focus on rationalizing and broadening the income tax base, and in this connection some Directors noted that revenues had been strongly influenced by external developments, particularly export growth. Government borrowing from banks would be further reduced, which would help contain total liquidity expansion while providing room for increased credit to support output growth in the private sector. A number of Directors underscored the importance of the Government's policies in that connection. Directors also noted the importance of careful control over credit flows to the private sector and in this respect welcomed the recent strengthening of the supervision of key nonbank financial institutions and the rationalization of their interest rates. With regard to bank interest rates, while some Directors believed that improved economic performance would permit some cautious reduction in lending rates, all supported the view that interest rates should not be reduced prematurely and that reductions should take into account inflation developments.

Directors noted that, despite the recent progress, much remained to be done in strengthening the production sectors and the balance of payments structure. Taking into account the external vulnerability of the economy and the fact that net foreign assets remained negative, Directors considered it essential to preserve the production incentives introduced by the recent exchange rate and other policy adjustments. The active and flexible exchange rate policy should be continued to sustain competitiveness in the export and import-substitution sectors. Efforts to improve productivity of public enterprises, which remained a source of concern to a number of Directors because of their continued weakness, should be urgently intensified through further rationalization and, where appropriate, transfers of their operations to the private sector. Some Directors also expressed the view that the World Bank could play a larger role in the development and diversification of the industrial and agricultural sectors. Some Directors also encouraged the World Bank to focus attention on the performance of the parastatals.

Directors focused their review of the medium-term balance of payments outlook on the issue of strengthening the current account position. They felt that a stronger current account was essential if growth were to continue without major disruptions as experienced in the recent past. In this regard, they noted that the medium-term scenario in the staff report partly reflected the authorities' objectives, rather than a forecast on present policies. Over the medium term a more sustainable balance of payments position should be achieved through a substantially reduced trade deficit, and measures to shift demand toward domestically produced foods and to strengthen productive incentives generally should be continuing features of economic policy.

Directors expressed concern over the current high debt service ratio and emphasized the importance of reducing it. In this context, they welcomed the authorities' intention to scale down the implementation of the largely foreign-financed development program to within the country's absorptive capacity. They also encouraged the authorities to minimize commercial borrowing, noting that the current high debt service burden had in part resulted from large commercial borrowings undertaken a few years ago. More generally, it was considered essential to contain external borrowing requirements by maintaining cautious financial policies and continuing the efforts to strengthen the productive sectors of the economy.

Directors commended the authorities for eliminating commercial arrears within a short period of time and their plan to eliminate the remaining arrears on official debt as soon as possible. They also welcomed the substantial liberalization of the import system and expressed the hope that a further liberalization would follow in the near future.

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

The Executive Board then took the following decisions:

Decision Concluding Article XIV consultation

1. The Fund takes this decision in concluding the 1984 Article XIV consultation with Western Samoa, in the light of the 1984 Article IV consultation with Western Samoa conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The existing restrictions on payments and transfers for current international transactions are maintained by Western Samoa in accordance with Article XIV. The Fund welcomes the substantial liberalization of the foreign exchange allocation system and the elimination of exchange restrictions evidenced by external arrears vis-à-vis other members of the Fund, and encourages the authorities to liberalize remaining exchange restrictions as Western Samoa's balance of payments position improves.

Decision No. 7899-(85/17), adopted
February 4, 1985

Review Under Stand-By Arrangement

1. Western Samoa has consulted with the Fund in accordance with paragraph 4(c) of the stand-by arrangement for Western Samoa (EBS/84/130, Sup. 1) and paragraph 4 of the letter dated June 5, 1984 from the Minister of Finance of Western Samoa, in order to reach understandings with the Fund regarding policies and measures and to establish performance criteria for the remaining period of the stand-by arrangement.

2. The letter dated January 4, 1985 from the Minister of Finance of Western Samoa shall be attached to the stand-by arrangement for Western Samoa, and the letter dated June 5, 1984 from the Minister of Finance and the memorandum annexed thereto shall be read as supplemented by the letter dated January 4, 1985.

3. Western Samoa will not make purchases under the stand-by arrangement that would increase the Fund's holdings of Western Samoa's currency in the credit tranches beyond 25 percent of quota or increase the Fund's holdings of that currency resulting from purchases of borrowed resources beyond 12.5 percent of quota during any period in which the data at the end of the preceding period indicate that:

a. the ceiling on net credit to the public sector from the banking system described in paragraph 13 of the letter of January 4, 1985; or

b. the ceiling on net domestic assets of the banking system described in paragraph 13 of the letter of January 4, 1985; or

c. the ceilings on external debt described in paragraph 9 of the letter of January 4, 1985, have not been observed.

4. The Fund decides, pursuant to paragraph 4(c) of the stand-by arrangement for Western Samoa, that the review provided for in that paragraph, including the specification of certain performance criteria for the remaining period of the stand-by arrangement, is completed.

Decision No. 7900-(85/17), adopted
February 4, 1985

3. HAITI - 1984 ARTICLE IV CONSULTATION AND REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1984 Article IV consultation with Haiti and a review of its stand-by arrangement (EBS/85/2, 1/4/85). They also had before them a report on recent economic developments in Haiti (SM/84/275, 12/21/84).

The staff representative from the Western Hemisphere Department stated that because of the difficulties that had developed during the second half of fiscal year 1983/84 with respect to the performance under the stand-by arrangement, the Haitian authorities had adopted a number of policy measures aimed at bringing the program back on track. Measures had been introduced to increase tax revenues, through both an improvement in tax administration and increases in the rates of the general sales tax and of various excise taxes; expenditure controls had been strengthened to prevent the recurrence of extrabudgetary outlays; the public sector's access to central bank credit had been reduced; and limits had been established on the expansion of credit from the state-owned commercial bank (BNC).

The staff had assisted the authorities in preparing quantitative guidelines to facilitate assessment of the adequacy of the measures taken, the staff representative went on. The authorities had agreed that presentation of a formal program to the Executive Board would be delayed until they had complied with the interim program being implemented.

Performance in October-December 1984 had not conformed to the aims established under that program, however, the staff representative continued. The data indicated that although performance had improved during the first two months of the current fiscal year, the economic position had deteriorated further during the third month. Treasury revenue had fallen short of target by about G 8-9 million. Although the interim program called for any shortfall in revenue to be matched by a downward adjustment in expenditures, expenditure for the quarter as a whole had exceeded the guidelines by G 12 million, or 5 percent. Furthermore, total credit to the public sector had exceeded target by some G 30 million; net domestic assets of the monetary authorities had risen by about G 45 million in October-December, compared with a limit of G 15 million established under the guidelines of the interim program; and credit from the BNC to the private sector had exceeded the end-December ceiling by some G 16 million. Consequently, the international reserve position of monetary authorities had failed to show much improvement since October, even though seasonal gains in reserves were customary in that period.

Mr. Kafka made the following statement:

> My Haitian authorities are in broad agreement with the staff's analysis and appraisal contained in the staff report. They do, however, feel that emphasis is somewhat lacking on the external events which together with domestic developments have

led to the interruption of drawings under the stand-by arrangement and have so far prevented the attainment of the results expected from the shadow program. They are fully resolved to bring the program back on track within the shortest possible period.

The external events which have bedeviled economic developments in Haiti include considerable damage to the tourist trade because of rumors about the danger of the disease Acquired Immune Deficiency Syndrome (AIDS) and civil disturbances in two provincial cities. These events have interfered with the execution of the budgetary retrenchment, the major objective of the Government. Although there was some improvement in export earnings by the assembly industry, government response to these developments required a significant reallocation of budgetary resources. It must be realized that in a country at a stage of development such as Haiti's, such reallocations are very difficult to achieve in the short run. Yet, even a very short delay in rearranging the economy in such a poor country causes major expenditure pressures, which now have to be overcome in order to proceed with the economic program adopted at the end of last fiscal year.

As the staff report correctly states, the Government has taken, since the occurrence of the food riots, measures with the help, or based over expenditures including, in particular, the expenditures of public enterprises. They have also introduced a considerable number of additional revenue measures and have taken action to improve control over the BNC reserve requirements and are ready, if necessary, to establish quantitative loan ceilings. They have also taken measures designed strictly to limit the use of external credit to grants and long-term concessionary loans and to limit severely the contraction of non-concessional external debt. They feel that their success in developing light industry fully justifies the maintenance of the parity of the gourde, in the context of the restrictive demand policies they are presently following.

The Haitian authorities agree with the staff's medium-term projections, which indicate as a broad conclusion that in the absence of major exogenous shocks and with sustained efforts in the fiscal and credit fields Haiti should be able to achieve a viable external position in the medium term, including a buildup in internal reserves. They stand ready to take further adjustment measures if the objectives to be pursued in the medium term for the purpose of reaching a sustainable balance of payments position should be threatened.

Mr. Joyce observed that the economic situation in Haiti was bleak. Per capita income was among the lowest in the world; the rate of unemployment in Port-au-Prince was about 35 percent, a figure that did not reflect the high underemployment; real GDP had declined in 1981-83; and economic growth in 1984 had been modest at best. The recent developments in Haiti and the failures under the present stand-by arrangement were distressing. That the authorities had not met the objectives of the interim program was even more disturbing.

The authorities had pursued appropriate economic policies under the previous stand-by arrangement and the early stages of the present stand-by arrangement, despite the economic difficulties facing the country, Mr. Joyce noted. The fiscal imbalances had been reduced significantly, and the balance of payments position had improved. That momentum had been lost in the past year. Looking back, it was unfortunate that the Fund had not insisted on a six-month review, as had been proposed by a number of Executive Directors at EBM/83/153 (11/7/83). The civil disturbances in May 1984 and the subsequent relaxing of policies by the authorities had worsened Haiti's economic situation, as had the more recent departures from the guidelines under the interim program formulated with the Fund staff.

The tax measures introduced in early 1984 had been an important step toward strengthening the public finances, but the authorities must clearly take additional steps to enhance revenues by improving tax administration, Mr. Joyce considered. He welcomed the technical assistance being provided by the Fund in that area. Better control over expenditures was also called for. The submission of the budgets of the public enterprises and of the Central Government for approval by the National Assembly was a step in the right direction. He wondered why the authorities did not apply monthly limits on expenditures of the public enterprises in addition to those applied to central government outlays.

The fiscal problems had been compounded by a weak monetary policy, particularly by a lack of effective control over credit extended by the BNC to the public sector, Mr. Joyce noted. The authorities should strictly enforce the tighter reserve requirements of the BNC, which were aimed at improving control over credit expansion.

The relationship between the Haitian gourde and the U.S. dollar had been stable since the early part of the nineteenth century, Mr. Joyce commented. Much could be said in favor of maintaining such a stable relationship. Although the gourde had appreciated in real terms since 1978, the economy had not been seriously affected. The authorities had successfully attracted light industry to Haiti, thereby reducing urban unemployment somewhat. However, if monetary and fiscal policies were not tightened soon, a stable exchange rate could not be maintained. The Haitian population suffered great economic disadvantages, and the authorities continued to face enormous challenges. The pursuit of more responsible monetary and fiscal policies in the coming months would pave the way for an improvement in the economy and the achievement of a more viable medium-term external position.

While he supported the authorities' efforts to correct the deteriorating economic situation, he would be reluctant to resurrect the recent stand-by arrangement, Mr. Joyce stated. The formulation of a new stand-by arrangement, once the authorities had met the aims of the interim program, would be more appropriate.

Mr. Nguyen recalled that at EBM/83/153 his chair had commented on the need for Haiti to restore the confidence of the financial community and to take appropriate adjustment measures to ensure sustained and balanced development. Those comments were still valid, as Haiti's situation had changed little and had perhaps even worsened. While a number of external events--including the hurricane in 1980, severe drought in 1982 and 1983, and the rumors about the dangers of AIDS--had been partly responsible for the economic deterioration, the present difficulties had also arisen from inappropriate economic and financial policies.

Following a period when the adjustment program had been roughly on track, the authorities had relaxed their policies and increased public spending as a result of the social unrest, Mr. Nguyen noted. In September 1984, however, the authorities had reached understandings with the Fund staff on the need to bring the program back on track. The implementation of an interim program seemed especially justified given the sharp increase in public spending that had resulted in excessive recourse by the public sector to central bank credit and a decline in foreign exchange reserves by more than $20 million. Although some objectives of the interim program, such as the achievement of a balance of payments surplus of $15 million in 1984/85, seemed ambitious, the overall guidelines for financial performance should be considered as a minimum requirement.

He agreed with the thrust of the staff appraisal, Mr. Nguyen commented. Fiscal policy was, to a large extent, at the root of the present problems. The efforts made to increase government revenues in recent years were commendable and there was still room for increases in tax revenues. However, the expected increase in revenues in 1984/85 would come mainly from taxes on gasoline, diesel, fuel, beer, alcoholic beverages, cigarettes, and travel insurance. He wondered when the recently introduced income tax would begin contributing to revenues. Improved tax collection and administration would yield increased revenues. Control over expenditures continued to be a major problem facing the authorities, but most of the extraordinary outlays had been of a nonrecurring nature, and some credits to finance the buildup of stocks of sugar and edible oil would be recovered. Monetary policy should clearly reflect the restrictive stance of fiscal policy, and the authorities' commitment to move toward quantitative loan ceilings, if necessary, to control credit expansion of the BNC was welcome.

Chart 3 of EBS/85/2 indicated that the gourde had appreciated in real terms by 16 points since the end of 1981, Mr. Nguyen noted. In Mr. Kafka's view the authorities' success in developing light industry fully justified maintaining the parity of the gourde. However, the costs and benefits of pegging the gourde to the U.S. dollar was questionable.

At what discount was the gourde being traded in the parallel market? The medium-term scenario was highly sensitive to changes in underlying assumptions, particularly with respect to coffee prices and the growth of imports and exports and clearly indicated the need for the authorities to pursue a flexible exchange rate policy.

Prospects for tourism were not clear, although the staff paper indicated that some improvement was expected in that sector, Mr. Nguyen observed. Could the staff or Mr. Kafka comment on recent developments? While the staff had addressed the main issues to which the authorities' attention should be directed in the short term, further action would be needed on the supply side, particularly in the agricultural sector, which employed two thirds of the labor force, represented 40 percent of export earnings, but accounted for only one third of GDP. The value added by that sector had declined in recent years. Haiti was not self-sufficient in food and had to spend scarce foreign exchange to import wheat. UN involvement in eradicating African swine fever was welcome. Measures aimed at improving coffee production and, particularly, marketing were also necessary. Could the staff elaborate on the authorities' farm pricing policies? Assistance from the World Bank in the agricultural sector was important and he would have appreciated more comments on the Bank's role in the staff paper. Haiti should improve the availability of statistics.

The problems faced by the authorities were difficult, and their solutions would involve considerable hardship and courage, Mr. Nguyen noted. There was no alternative but to stick to the interim program, however, and the encouraging measures that had been undertaken in many areas would enable the authorities to formulate a new adjustment program that could be supported by the Fund.

Mr. Steinberg observed that most of the Fund arrangements with Haiti in the past decade had not been satisfactorily completed. A detailed presentation of Haiti's performance under those arrangements would have been more useful than the summary in the appendix to EBS/85/2. Only one of the five targets of the current arrangements had been met.

The authorities were apparently interested in resurrecting the stand-by arrangement as evidenced by the staff's preparation of an interim program, but the purpose of the interim program was unclear, Mr. Steinberg commented. Was it intended to steer the economy back on track by correcting the deviation from the original program or was it a face-saving mechanism that would allow the authorities to verify their good intentions to the Board before a new arrangement was drawn up? More details on how and when the authorities would return to the existing program was necessary. No targets had yet been established for the second year of the program, and he wondered whether the authorities were envisaging drawing on Fund resources.

A better understanding of the nature of, and reasons for, the deviations from the original program was essential before the Board could evaluate the authorities' ability to bring the program back on track, Mr. Steinberg considered. The staff report indicated that the rapid increase in public sector spending, following the disturbances of May 1984, had been largely responsible for the deviations from the budgetary objectives. Performance on the revenue side had also been poor, largely because of administrative difficulties regarding the new sales tax, taxpayer resistance, and the lack of trained tax collectors. Given those problems, he wondered whether the higher tax rates planned by the authorities might lead to lower rather than higher receipts. Priority should be given to improving tax administration in general, and Fund technical assistance in that area was welcome.

The staff attributed the extraordinary increase in expenditures to weak control by the Central Government and the free distribution of food and the creation of more jobs in reaction to the May 1984 civil disturbances, Mr. Steinberg noted. A decision to allocate free food and create jobs was obviously made by the highest authorities and, thus, could not be classified as inadequate control. Could the staff provide additional information on the authorities' lax control over expenditure?

The medium-term scenario prepared by the staff contained some promising developments, Mr. Steinberg considered, but the authorities should note the sensitivity of the projections to the underlying assumptions--in particular, the pursuit of prudent fiscal and monetary policies that would encourage exports. While exchange rate policy had not been discussed in the context of the medium-term scenario, the authorities would apparently continue their policy of maintaining the parity with the dollar--a tradition that supposedly reflected stability and discipline. Although the staff had indicated that the maintenance of the parity of the gourde would require the pursuit of restrained monetary and fiscal policies, it did not analyze the appropriateness of the current exchange rate.

The real effective exchange rate had appreciated considerably between 1978 and mid-1984, Mr. Steinberg noted. The authorities considered that Haiti's external competitiveness was measured better in relation to unit labor costs than to the cost of living, a valid argument if data on those variables were available. In Haiti, however, comprehensive figures on labor costs were not available. The appropriateness of Haiti's exchange rate policy was a crucial question given the weak balance of payments position and adverse external developments in recent years. A more thorough analysis of that policy by the staff was called for before the Executive Board could pass judgment on its appropriateness.

Ceilings regarding credit to the public sector and net domestic assets of the monetary authorities had been breached as a result of the expansion of credit from the central bank to the public sector, Mr. Steinberg commented. Central bank control over credit expansion by the BNC--which had provided about 90 percent of commercial credit to the private sector in 1984, a year in which total credit to that sector had grown by only 8 percent--should be improved both quantitatively and qualitatively. Care should be taken, however, to avoid crowding out of the private sector. In conclusion, it was unclear whether the adjustment program could be brought back on track, but as the authorities wished to continue adjustment with Fund support, an interim program seemed appropriate. Nevertheless, developments should be monitored closely to ensure that the original program objectives had been met before a new program could be proposed.

Mr. Wicks remarked that Haiti's performance under the stand-by arrangement had been disappointing; three of the four sets of performance criteria had not been observed and the relatively limited aims of the program had not been met. Gross reserves had fallen and the public sector deficit, although marginally smaller, had been two and one half times larger than projected. It was unfortunate that the Board had not had the opportunity to discuss the economic situation in Haiti for nearly 14 months; as there had not been a midterm review, discussion on the Article IV consultation should have been held on schedule or preferably some months earlier. The authorities' decision to follow an interim program designed to put the economy back on track was encouraging, but he was disappointed to learn from the staff about the lack of progress under that program.

Substantial improvements in expenditure control were urgently needed given the substantial extrabudgetary expenditures in 1984, which appeared to have been funded by the parastatals, Mr. Wicks indicated. The authorities needed to demonstrate a real commitment to fiscal restraint and he wondered whether any special measures were in sight. The serious problems regarding tax administration were disappointing, particularly in view of the Fund's technical assistance in that area. While some progress had been made, more needed to be done.

The balance of payments position would remain precarious in the medium term, Mr. Wicks noted. The projected increase in international reserves in 1985 was based on the assumption that the authorities would be able to make all further drawings available under the current arrangement. For 1986 and beyond, the projected balance of payments surpluses were only slightly more than necessary to cover repayments to the Fund and left no room for maneuver should developments be less favorable than expected, particularly with relation to the U.S. economy and coffee prices. At EBM/83/153 (11/7/83) he had expressed concern about the appropriateness of the exchange rate policy given the substantial real appreciation of the gourde since 1982 and the importance of price-sensitive light manufactures in exports. He still had doubts on that score, particularly in view of the continued existence of the parallel market, although the discount on that market had been reduced. But the freeze in nominal minimum wages between 1981 and October 1984 had clearly mitigated any effects of the exchange rate on competitiveness, and light manufactures remained buoyant. He wondered if the staff could comment on the combined effect of the real effective appreciation of the gourde and wage restraint on exporters' profit margins. The effect of exchange rate policy on that sector could be better assessed if Haiti's competitors in the light industry field were identified.

Haiti had met only one of the four sets of performance criteria under the first year of the program, and by any standards the economy had been substantially off track for most of the period, Mr. Wicks continued. It was therefore unfortunate that Haiti had been able to purchase three fourths of the resources available for the year. Three conclusions could be drawn from Haiti's experience: purchases under the program should have been more back-loaded; there should have been a midterm review of the program; and, in some cases, unfortunately, all previous drawings could be unlocked when one set of performance criteria, defined as cumulative limits, were met. The use of cumulative limits could on occasion give rise to anomalies, and he would appreciate the staff's comments on that problem. He would be concerned if the approval by the Executive Board of a second year of the stand-by arrangement would unlock all previous drawings. What were the staff's assumptions in its 1985 balance of payments projections in that regard? Haiti needed to demonstrate over a considerable period of time that it was capable of implementing and sustaining adjustment policies before it could make use of Fund resources under another arrangement.

Mr. Grosche said that it was regrettable that the current stand-by arrangement had gone substantially off track. While some of the difficulties facing Haiti had stemmed from adverse exogenous factors, the main problems arose from inadequate domestic policies, particularly fiscal and monetary policies. The authorities had recognized the urgent need to reverse the recent trend, and he welcomed their willingness to undertake the necessary policy adjustments within the framework of an interim program agreed with the staff. Those measures should permit an early return to a formal program approved by the Executive Board. The authorities should take corrective action immediately as any slippages in the implementation of the measures under the interim program could lead to a serious balance of payments crisis. The authorities' difficulties in implementing the interim program raised doubts about whether the current inoperative stand-by arrangement could be brought back on track. In particular, the projected improvements in the public sector finances and in the overall balance of payments were unrealistic.

The real effective appreciation of the gourde had led to some loss of competitiveness in markets other than the United States, Mr. Grosche noted. A more flexible exchange rate policy might be more appropriate, but, as the United States was the major export partner and as Haiti was still competitive owing to low labor costs, there was no pressing need for an active exchange rate policy. Strict monetary and fiscal policies were essential to maintain Haiti's cost advantage, however.

In sum, substantial adjustment was necessary, and great importance should be attached to an even distribution of the adjustment burden to prevent further social unrest, Mr. Grosche considered. Furthermore, as unemployment was substantially higher in urban than in rural areas, migration to the capital should be curtailed by ensuring more even growth.

Mr. Ortiz asked the staff to explain the differences in the figures on the top of page 4 and in Table 2 of EBS/85/2 regarding the public sector deficit not financed by concessional external aid. The practice of excluding expenditures financed by credit on concessional terms from the public sector deficit was inconsistent with other programs presented to the Board. He was concerned about the definition of the public sector deficit because the staff gave the impression that the adjustment effort under the previous stand-by arrangement had been successful until fiscal year 1982/83. Table 2 indicated, however, that the public sector deficit had been narrowed almost exclusively as a result of the increase in concessional loans from 2.6 percent of GDP in 1982 to 4 percent of GDP in 1983, and the overall deficit of the public sector including grants in aid had, in fact, widened from 5.4 percent of GDP to 5.9 percent of GDP in those years.

Haiti's performance under the most recent stand-by arrangement had fallen short of the program's objectives, Mr. Ortiz noted. The increase in extrabudgetary expenditure, largely financed with central bank credit, and the shortfall in revenue represented the major deviations from the program targets. Consequently, the overall deficit of the public sector had been 2.2 percentage points larger than projected, although the higher than expected public enterprise surplus had partially offset that deviation. The combined effect of the lower than projected grants in aid and larger than expected amortization of nonconcessional loans amounted to 0.6 percent of GDP.

Those figures indicated that success on the fiscal front in 1982/83 had not been as successful as had been indicated in the staff paper, Mr. Ortiz stated. In fact, the overall deficit of the public sector had actually increased between 1983 and 1982, although it had declined again in 1984. The shortage of external financing was one of the main causes of the deviations from the program, and it was therefore not surprising that the ceilings on credit to the public sector from the monetary authorities and the BNC had been exceeded. The breach of those ceilings as a result of financial shortages should not be considered as disturbing as the deviations arising from the higher than expected expenditures. Although it was generally the case that the poorer the country the more vulnerable it was to external shocks, the Fund sometimes tended to overlook that point and judge deviations in terms of a strict yardstick. While fiscal and monetary discipline was essential in countries undergoing adjustment--independent of their level of per capita income--foreign aid, grants, and technical assistance from the international community were also necessary to ensure a viable balance of payments position in the medium and long term.

The authorities were apparently interested in continuing adjustment under the current stand-by arrangement, but, given the size of the deviations from the targets, purchases had been suspended in April 1984, Mr. Ortiz noted. The authorities would have to comply with the guidelines under the interim program in 1984/85 if the Fund was to consider approving a new program of reviving the old one. Such a requirement implied that Fund resources, rather than being made available according to a country's balance of payments need, would represent a reward for the authorities' compliance with the interim program. Could the staff comment on that issue?

The authorities had introduced a number of tax measures aimed at balancing the 1985 budget, Mr. Ortiz remarked, but the staff reports on Haiti indicated that about one half of the possible taxpayers were not submitting tax declarations and that considerable tax evasion was evident from those individuals that were submitting declarations. A disproportionate share of the tax burden, in the form of indirect taxes, was borne by a limited number of consumers. Emphasis should be directed toward improving tax administration and avoiding evasion rather than on increasing the tax rate on a small proportion of consumers. Additionally, highest priority should be given to controlling extrabudgetary expenditures.

The weak tax structure had probably encouraged the staff to formulate a tight monetary policy, which was the easiest way to monitor the Government's activities, Mr. Ortiz considered. Internal credit expansion was limited to 3.5 percent in 1984/85, representing a severe contraction in real terms, and monthly guidelines would be established for the financial aggregates and the operations of the Treasury. Was the staff being too restrictive on the monetary side to overcompensate for fiscal imbalances that were difficult to detect?

He would be interested to hear about the macroeconomic assumptions underlying the balance of payments projections, Mr. Ortiz stated. Although the staff had presented an explanation of the assumed evolution of imports, exports, and capital flows, no reference had been made to the behavior of the other key macroeconomic variables, including the effects of evolution of the exchange rate and the behavior of prices on output. The balance of payments situation projected through 1990 in Table 8 of EBS/85/2 could not be considered as viable if the economy remained stagnant or if per capita consumption declined continuously as in the past.

Mr. Weitz noted that after a number of years of economic deterioration, Haiti had adopted a Fund-supported stabilization in early 1982. The public sector deficit had been reduced, and the balance of payments position strengthened. In late 1983, the authorities had embarked on a new program with the aim of enhancing the public finances and improving the country's international reserve position. Unfortunately, owing to a combination of external and internal factors, the program had not been implemented as planned. The tourism sector had been negatively affected.

The interim program was appropriate, Mr. Weitz considered. Its implementation would improve the external sector and help to restore confidence in the economy. However, the staff had indicated at the present meeting that the economic situation was not improving, and the authorities should take the necessary measures to turn the economy around.

The parity of the gourde could be maintained only if restrictive demand management policies were applied, Mr. Weitz observed. On monetary policy, the reserve requirement rules with respect to the BNC should be strictly enforced, and the credit policy of the BNC should not be determined independently of the overall objectives of the monetary and credit program. Could the staff indicate whether all public enterprises were being requested to submit their budgets for approval by the National Assembly in conjunction with central government budget? The receipts from new sales tax had fallen short of expectations owing to difficulties in tax administration and to an intensification of taxpayer resistance. The authorities should implement additional measures in that area. It would be useful to have more information from the staff about the role of the World Bank in Haiti and about technical assistance from the Fund.

Ms. Bush commented that Haiti's deviation from the adjustment program, owing partly to the disturbances of spring 1984 and the resulting increases in government expenditures, was regrettable, particularly as Haiti had made progress in reversing the earlier economic decline. Despite the problems discussed by the staff, Haiti could maintain adjustment in the long term if the authorities were to implement a more restrained fiscal policy and the structural measures necessary to sustain growth in the long term.

Equitable collection of taxes could be effective in encouraging widespread cooperation with the fiscal effort, Ms. Bush noted. She had, however, some reservations about the coffee export tax and the coffee sector in general. A sizable proportion of revenues from coffee production accrued to intermediaries and the Government through the tax on coffee exports, and she wondered if the value added by the intermediaries was sufficient to warrant the revenues that they received. Although the share of export tax in revenues from coffee had declined, she wondered whether it continued to consume too large a share of revenue from an important sector of the Haitian economy. The fundamental question was whether sufficient incentives were being provided to the most appropriate segments of the coffee sector?

The staff had also questioned the structure of coffee production which was largely grown on small farms rather than on large plantations as in many coffee-producing countries, Ms. Bush went on. Various international agencies had attempted to restructure coffee production in Haiti by encouraging the establishment of new plantations. However, these efforts had not been successful. Was the World Bank's expertise in that area being utilized? The staff had indicated that the small farms were less likely to give the proper care to soil and trees that would keep them productive for extended periods and that the lack of appropriate maintenance had contributed to the two-year coffee cycles in Haiti. Would an increase in the price paid to producers stimulate the kind of maintenance that was necessary? The expenditure side of the 1985 budget was restrained, but the authorities should monitor the expenditures of the ministries, avoid extrabudgetary outlays, and enforce the procedures for approval of public enterprise budgets by the National Assembly. As the evolution of new revenues was not yet clear, the authorities should take stronger steps to control expenditure in order to achieve, and even surpass, their goal of reducing the deficit to 6.1 percent of GDP in 1985.

The interest rate structure appeared appropriate, although private savings at about 4 percent of GDP remained below the 1982 high of 6.8 percent of GDP, Ms. Bush noted. However, the balance of payments table did not indicate a capital flight problem. Additionally, the consolidated accounts of the banking system indicated that net credit to the private sector would increase by only 5 percent in 1985. Adequate credit must be made available to the private sector to restore confidence. However, a reduced fiscal deficit would reduce financing needs, thereby freeing more resources for the private sector.

Haiti had made extended use of Fund resources under several programs, Mr. Bush noted. Although the Haitian economy was not subject to the myriad of production and price controls that were frequent in a number of developing countries, it failed to develop and grow rapidly even in those areas that appeared to have the potential to expand. Could the staff shed any light on why the assembly sector was performing well; were there lessons that could be transferred from that sector to other sectors of the economy? The fiscal imbalances were a significant problem; in the past five years, the fiscal deficits had equaled or exceeded 8 percent of GDP. Furthermore, structural rigidities in the marketing of coffee had been detrimental to the expansion of the economy's productive base and had contributed to the high level of unemployment. Those structural and general economic problems must be addressed forthwith in order to improve Haiti's economic performance. To be effective, Fund assistance--whether financial or advisory--must deal with those types of problems. Given Haiti's use of Fund resources over an extended period, the authorities must act forcefully to correct their problems and diminish the country's reliance on Fund credit.

The staff representative from the Western Hemisphere Department, commenting on questions relating to the definition of fiscal imbalances, stated that Haiti received considerable financial assistance in the form of soft loans. As such assistance put little weight on the balance of payments position in terms of service obligations, the staff had focused on domestic financing and nonconcessional commercial borrowing in defining the fiscal imbalance. In fact, Haiti had made relatively little use of commercial loans until recently. For purposes of intercountry comparison, however, all forms of financing, including grants, should be presented in the balance of payments and the fiscal accounts.

In the text on page 4 of EBS/85/2, the staff had rounded the numbers with respect to the public sector deficit as percent of GDP for 1981-83 presented in Table 2 on page 5, the staff representative explained. The public sector had registered a deficit of 1.8 percent of GDP in 1984, rather than the programmed deficit of 0.7 percent of GDP, owing to a shortfall in revenues and a greater than projected expansion in current expenditures. Although the transfers of the public sector enterprises to the Government had met some of that shortfall, the overall public sector had deteriorated significantly in 1984 as evidenced by the use of credit from the banking system to service certain foreign obligations. The public sector had been unable to obtain new financing of a commercial nature because of Haiti's limited creditworthiness in the commercial markets; the staff had encouraged the authorities to limit the use of commercial credit to finance imports and transactions of a self-liquidating nature.

The fiscal situation had deteriorated sharply after May 1984 largely as a result of the increase in expenditures by the Government following the civil unrest, the staff representative indicated. Some of those expenditures had been identified clearly, including the distribution of free goods and the creation of jobs, but other outlays had been difficult to identify. The authorities had been pursuing a fiscal reform program under the previous arrangement supported by the Fund. Further efforts were needed to strengthen the administration and collection of existing taxes and the control over expenditures. Tax evasion was high in Haiti. Though the staff would normally be opposed to increasing the tax rates in such circumstances--as revenues did not react rapidly to administrative measures--it had supported the authorities' proposal to increase a number of tax rates. Nevertheless, the fundamental need was to increase the tax base, and the Fund was providing technical assistance in that area.

The Fund was also providing technical assistance to improve the administration of the budget and control over expenditures of the Treasury, the staff representative went on. The problem of extrabudgetary expenditures was one that the authorities would have to deal with themselves, although the Fund could help them devise an appropriate system of controls.

A further reduction in the coffee tax was not the best course of action at present, the staff representative commented. However, a number of sectors of the population had been pressing for a reduction of the coffee tax in an effort to encourage production in that sector. In the appendix to SM/84/275 the staff had shown, at the request of the authorities that, despite a significant reduction in the rate of coffee tax over a long period, production had continued to decline. The coffee sector was complicated in terms of the organization of marketing and the structure of production. Coffee was grown on small farms, and when the world price for coffee increased the farmers would harvest more intensively. When the world price for coffee declined, the farmers harvested less. A small group of middle management entrepreneurs controlled the marketing of coffee, and the staff considered that a reduction in the coffee tax was unlikely to be passed on to the farmers and would therefore provide little incentive to increase production. A number of international agencies had examined the coffee sector, and some projects had been undertaken to develop new plantations, but such efforts had been relatively unsuccessful to date.

The World Bank was not specifically involved in the coffee sector but was the largest international agency providing funding in Haiti, the staff representative indicated. The Bank had provided loans for rural development in the north of Haiti, urban development projects in Port-au-Prince, electric power generation and distribution, forestry, and highways in the interior of the country. It was also involved in providing industrial credit. The possibility of providing nonproject sectoral loans was being considered, but the staff report had not yet been presented to the Bank's Executive Board.

No ceilings on credit to the private sector from the banking system had been included in the economic program with Haiti, the staff representative remarked. However, the staff had established a ceiling on credit from the BNC as its portfolio of loans had been of relatively poor quality owing to its recent separation from the central bank. There had been so many bad loans that the authorities had issued a government bond as part of the cleanup operations. The credit ceiling had been established to ensure that the bank did not exceed its lending requirements and that the loans were of good quality. In 1984, the BNC had used resources obtained from the collection of taxes--as a financial agent of the Government in the provinces--to expand its provision of credit. The staff's proposal to tighten the credit of the BNC was not intended to restrict credit to the private sector. In the past two years, the commercial banks had been able to meet the private sector's demand for credit, which had been low owing to the lack of confidence on the part of private investors.

The discount in the parallel market was in the order of 8-10 percent, slightly higher than a few months previously but not as high as in the past when the reserve situation had been tight, the staff representative commented. The maintenance of a stable exchange rate had been of great importance in attracting foreign investment in Haiti. The authorities recognized that strict fiscal and monetary policies must be pursued if a stable exchange rate policy were to be sustained and that efforts to restore fiscal stability had been aimed at maintaining the parity of the gourde. They had expressed concern about the real effective exchange rate of the gourde vis-à-vis the country's trading partners, but they had felt thus far that maintaining the stability of the gourde was of the utmost importance, and, to that end, had indicated their willingness to adjust monetary and fiscal policies. However, their performance in those two areas had not always been positive.

The export sectors, particularly the assembly industry, had continued to grow in recent years despite the recession in the United States and the appreciation of the exchange rate, the staff representative noted. The number of firms involved in the assembly industry had increased significantly in the past five years. Haiti's competitors in the Western

Hemisphere with respect to the assembly industry included Mexico, the Dominican Republic, Honduras, Brazil, and some of the other Central American countries. In the Far East, the Philippines, Thailand, Korea, and Taiwan Province of China were also involved in similar industries. Haiti's position with respect to relative wages had deteriorated slightly since 1976, but because of its proximity to the larger markets, such as the United States, the country's overall competitiveness remained fairly high. No detailed information was available on the assembly industry, but it had been a growing source of employment in Haiti and had surpassed coffee as a foreign exchange earner in recent years.

The competitiveness of the agricultural sector was considerably more difficult to measure because of the lack of available data, the staff representative from the Western Hemisphere Department remarked. However, the minimum wage announced by the Government was probably higher than the wages paid to the rural population, indicating that Haiti had a substantial cost advantage over its competitors with respect to agricultural production.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/85/16 (1/30/85) and EBM/85/17 (2/4/85).

4. NEW ZEALAND - TECHNICAL ASSISTANCE

In response to a request from New Zealand for technical assistance in connection with the introduction of new indirect tax measures, the Executive Board approves the proposal set forth in EBD/85/35 (1/28/85).

Adopted February 1, 1985

5. ST. LUCIA - TECHNICAL ASSISTANCE

In response to a request from St. Lucia for technical assistance in the form of a survey of the tax system and its administration, the Executive Board approves the proposal set forth in EBD/85/36 (1/28/85).

Adopted February 1, 1985

6. SOMALIA - FUND REPRESENTATIVE

The Executive Board approves the recommendation of the Committee on Administrative Policies to establish a resident representative post in Somalia as set forth in EBAP/85/21 (1/28/85).

Adopted January 31, 1985

7. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 84/95 through 84/98 are approved (EBD/85/37, 1/28/85).

Adopted February 1, 1985

8. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/85/23 (1/29/85) and EBAP/85/26 (1/30/85), and by an Assistant to Executive Director as set forth in EBAP/85/25 (1/30/85) is approved.

APPROVED: October 30, 1985

LEO VAN HOUTVEN
Secretary