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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/59

3:00 p.m., April 15, 1985

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	A. K. Diaby, Temporary
	M. K. Bush
	M. Lundsager, Temporary
	G. Ercel, Temporary
B. de Maulde	
	A. Mustafa, Temporary
	M. Sugita
G. Grosche	
J. E. Ismael	
	G. D. Hodgson, Temporary
A. Kafka	H. A. Arias
H. Lundstrom	
	A. Abdallah
	B. Jensen
	E. M. Taha, Temporary
P. Pérez	
J. J. Polak	
	H.-S. Lee, Temporary
	R. Msadek, Temporary
	A. S. Jayawardena
	T. A. Clark
	N. Coumbis
	Wang E.

L. Van Houtven, Secretary
K. S. Friedman, Assistant

Also Present

G. Koenig, Latin America and the Caribbean Regional Office, IBRD. Exchange and Trade Relations Department: M. Guitián, Deputy Director; M. Nowak, P. J. Quirk, M. O. Tyler. External Relations Department: H. P. Puentes. Fiscal Affairs Department: H. Bierman. Legal Department: J. M. Ogoola. Treasurer's Department: E. Decarli. Western Hemisphere Department: S. T. Beza, Associate Director; M. Caiola, J. E. González, R. Incer, T. P. McLoughlin, J. P. Pujol, S. J. Stephens, F. van Beek. Bureau of Statistics: E. Matayoshi. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: G. E. L. Nguyen. Assistants to Executive Directors: J. R. N. Almeida, I. Angeloni, J. de la Herrán, W.-R. Bengs, R. Fox, Z. b. Ismail, J. A. K. Munthali, E. Olsen, A. H. van Ee.

1. DOMINICAN REPUBLIC - STAND-BY ARRANGEMENT, AND EXCHANGE SYSTEM

The Executive Directors considered a staff paper on a request from the Dominican Republic for a one-year stand-by arrangement for an amount equivalent to SDR 78.5 million (EBS/85/75, 3/27/85). They also had before them a background paper on the exchange arrangements and exchange system of the Dominican Republic (EBS/85/76, 3/27/85).

The staff representative from the Western Hemisphere Department commented that the preliminary data through end-March 1985 indicated that the program was on track, as the authorities had remained within all the quarterly ceilings by a considerable margin. On March 31, 1985, combined net credit from the Central Bank and the Reserve Bank to the public sector had been approximately RD$52 million less than expected, and the net domestic assets of the Central Bank had fallen by some RD$48 million, compared with the expected increase of RD$100 million. Similarly, while the staff had expected a decline in net foreign assets of approximately RD$24 million, there had actually been an increase of some RD$15 million. There had also been a substantial decline in external arrears, and the staff expected that the June 30, 1985 target of a cumulative cash reduction in arrears of US$64 million would be observed with a sizable margin.

The exchange rate had moved from RD$3.35 per US$1 in early February 1985 to the present rate of approximately RD$3.19 per US$1; the movement had been particularly pronounced since early April, the staff representative from the Western Hemisphere Department said. The Government's request for debt relief from official creditors was scheduled to be discussed by the Paris Club in late May 1985. Substantial progress had been made in the debt relief discussions with the Dominican Republic's commercial bank creditors: it had been agreed that payments of principal falling due in 1985-89 would be rescheduled. The discussions were continuing on the repayment period and the interest rate. The commercial banks had proposed a 12-year repayment period, a 2-year grace period, and an interest rate 1 1/2 percent above LIBOR. The authorities had requested a somewhat more liberal repayment period and a lower interest rate, and a final agreement was expected in the near future. The banks had also indicated that they intended to make available US$30 million in trade financing to the Dominican Republic, which had initiated the process of liquidating its unpaid letters of credit through the use of collateral deposits. In the circumstances, there appeared to be no difficulty in covering the balance of payments financing gap.

Mr. Arias made the following statement:

> The facts of the recent economic performance of the Dominican Republic were explained in Mr. Kafka's statement to the Executive Board during the 1984 Article IV consultation (EBM/84/125, 8/8/84). Thus, I would like to concentrate on the efforts that the Dominican authorities have made to prepare a new economic program.

Before reviewing how negotiations evolved, I should explain that the authorities have maintained close contact with the staff in the elaboration of economic policies. In formulating their adjustment policies, the authorities had to consider the violent reaction caused by the adjustment measures taken early in 1984, which comprised moves toward the depreciation and reunification of the exchange rate. The par value of the peso had been pegged to the dollar for 50 years. The steps taken in April 1984 involved the transfer to the parallel market of almost all nonpetroleum imports and the consequent increase in domestic prices of many basic foodstuffs. Therefore, the subsequent adjustments had to be implemented very cautiously, giving ample time to prepare public opinion. In this context, the authorities recognize the need to strengthen the balance of payments position further. For this purpose, in August 1984 they adopted additional measures in the fiscal and external areas called for by Executive Directors during the latest Article IV consultation, under the bridge agreement implemented without Fund resources.

The key adjustment measures envisaged in the program were adopted in late January 1985, before the signing of the letter of intent. The primary objectives of the 1985 program--which my authorities feel confident will be achieved--are to reduce the internal and external financial disequilibria and re-establish the conditions for sustainable economic growth. The program provides for the radical reduction in the ratio of the current account of the balance of payments to GDP from 4.3 percent in 1984 to 0.6 percent in 1985 and also for a substantial decline in the fiscal imbalance. Among the most important measures taken in the context of the program is the unification of the exchange rate. This measure will have far-reaching effects and provides clear evidence of the authorities' determination to achieve a viable balance of payments position over the medium term. The program places prudent limits on disbursements of nonconcessional public sector loans, in view of the Dominican Republic's serious external debt situation. Moreover, a major rescheduling exercise with both official creditors and the commercial banks is envisaged, as well as the liquidation of a large part of the external arrears outstanding at end-1984.

As is also explained in the staff report, the Dominican authorities will attempt to reduce the public sector deficit from 7.5 percent of GDP in 1984 to 4.9 percent in 1985. Apart from the revenue measures of July 5, 1984, detailed in SM/84/161, improvements in public finances are to be achieved basically through levying temporary export surcharges at rates of 36 percent on most traditional exports and 5 percent on most nontraditional exports. Revenue collections will also benefit from price adjustments for petroleum products and from valuing imports at the actual exchange rate. Moreover, the increase in electricity rates by 50 percent will strengthen significantly the financial position of the Electricity Corporation. The Dominican authorities recognize that these revenue measures need to be accompanied by a tightening of expenditure controls. In this context, a policy of wage restraint and improvement in the efficiency of public sector enterprises will be key factors in the program.

Another area in which the Dominican authorities are concentrating their efforts is in strengthening the financial performance and position of the Central Bank. To these ends, emphasis will be placed on the improvement of credit allocation, together with a more flexible interest rate policy, so as to foster domestic savings and discourage capital outflows. Also, as pointed out by the staff on page 9 of the report, a set of control measures has been put into place to enhance the liquidity position of the Central Bank. My authorities believe that these measures will improve the financial situation of the Central Bank and allow it to increase its net international reserves by US$109 million in 1985. Another important step highlighted in the program is that no credit expansion by the banking system to the public sector will be allowed other than for strictly seasonal purposes.

With regard to external debt obligations, a financing gap of US$336 million is in prospect, excluding debt relief. Discussions with the commercial banks are progressing satisfactorily, and a meeting of the Paris Club is in prospect for May. In the circumstances, the authorities have no doubt that the financing gap will be closed satisfactorily.

The authorities are determined to pursue the necessary adjustment measures to promote financial stability and regain a stable and substantial growth rate. For this purpose, they have implemented an economic program, which, until the first review, is being supported by the Fund by a purchase in the first credit tranche. After the first review is completed, in mid-August, subsequent purchases will be in the upper credit tranches. At that time, performance criteria for end-September and December will be established, and the financing gap will have been closed. I hope that my colleagues can support the Dominican Republic's request.

Mr. Nebbia commented that during the previous several years the Dominican Republic had faced many of the same problems that had confronted other Latin American countries, including a sharp deterioration in the terms of trade, restricted access to export markets, and high real interest rates on external debt. Developing countries striving to preserve democracy often had difficulty in implementing measures that other countries found appropriate for eliminating internal and external imbalances. In the Dominican Republic, the adjustment measures adopted under the previous Fund-supported program had caused violent social upheavals in early 1984.

The important and courageous measures that the authorities had already introduced, including the unification and floating of the exchange rate, and the adjustment of prices and public tariffs, deserved the Fund's strong support, Mr. Nebbia went on. Nearly all the measures that the Executive Board and the staff had recommended during the previous Article IV consultation had been implemented or were included in the proposed stand-by arrangement.

The proposed program, Mr. Nebbia continued, contained a number of strong measures and significant objectives: a major improvement in public finances; a prohibition on salary increases in the public sector unless the Congress approved compensatory revenue or expenditure measures; restoration of realistic cost-price relations for tariffs, oil, and foodstuffs; avoidance of domestic bank financing by the public sector; and the continued free floating of the exchange rate. A national consensus was needed to ensure the success of the new program.

He agreed with the staff that adjustments in key prices might negatively affect the rate of inflation in early 1985, Mr. Nebbia said. In the financial sector, the more flexible interest rate policy and the reduction of the minimum denomination of financial certificates were significant steps toward ensuring a more efficient allocation of resources, discouraging capital outflows, and permitting the financial system to make the necessary adaptations to the new exchange rate policy. Additional improvements in the financial system would be welcome, and the staff's latest information on the trend in the exchange rate were welcome.

The country's export performance depended upon developments in the markets for a small number of products--particularly sugar, coffee, cocoa, tobacco, and several minerals--the outlook for which was poor, Mr. Nebbia went on. The authorities should make a major effort to increase the value of nontraditional exports, and the new exchange rate policy was an important step in that direction. Finally, he strongly supported the proposed decisions.

Mr. Blandin stated that the proposed stand-by arrangement was acceptable. Recent developments clearly demonstrated that there was no alternative to making needed adjustments, with or without Fund assistance; adjustment was invariably more painful when imbalances had become pronounced and necessary measures had been delayed. However, adjustment that was not made in the context of an overall effort to restore economic growth would be intolerable, especially for a country like the Dominican Republic, which had a long tradition of steady, noninflationary growth. He was therefore particularly pleased that the investment trend in the Dominican Republic had more or less been preserved.

He was also pleased that despite some misunderstandings a dialogue between the authorities and the Fund had been maintained, making possible the implementation of an interim program that had set the stage for the proposed arrangement, which covered a shorter period than the previous program and would provide a relatively moderate amount of Fund resources, Mr. Blandin continued. Still, the new program seemed appropriate to the circumstances of the Dominican Republic and provided sufficient guarantees for the financial community. The staff's assessment of the underlying conditions and the proposed performance criteria was adequate; the program was well designed, and the authorities were fully committed to implementing it.

He agreed with the staff that the authorities should maintain stricter demand management policies and firm wage restraint, Mr. Blandin went on. The expected reduction in the fiscal deficit from 7.5 percent to 4.9 percent of GDP was modest but in the right direction, and the financing gap would be covered entirely by external sources. The measures that the Government had implemented or planned to introduce to control expenditures and reform prices of the public enterprises were promising, but the authorities should be urged to replace the taxes on exports with more permanent fiscal measures as soon as possible. As to monetary policy, the rate of increase in the money supply was to be kept roughly in line with the rise in real GDP. The authorities' intention to maintain a more active interest rate policy to encourage domestic savings and to improve the Central Bank's control over the expansion of domestic liquidity was useful.

The long-awaited unification of the exchange rate had finally occurred, although the continued existence of multiple exchange rates was regrettable and would clearly warrant close monitoring, particularly in the light of experience, Mr. Blandin said. As to the trade balance, he agreed with the staff on the need for greater diversification away from the traditional sectors with poor prospects, such as sugar and mining, and toward more promising areas, such as tourism and new agricultural activities.

He also agreed that additional fiscal measures were needed as part of the effort to make changes that were essentially structural, Mr. Blandin continued. In that context, the most important area was investment, where some curtailment was expected in the coming period. The viability of some investment projects would have to be reassessed, but the fact that the ratio of investment to GDP had remained fairly high--21.7 percent--was encouraging. It would be crucial to generate a high rate of domestic savings and to encourage domestic investment, which was expected to decline somewhat in 1985, and the staff had correctly stressed the need for further collaboration with the World Bank, especially on the formulation of appropriate medium-term goals. The World Bank's technical advice and financial assistance thus far had demonstrated that the actions of the Fund and the World Bank on behalf of a member country could be complementary and need not involve the cross-conditionality that some Executive Directors seemed to fear.

In sum, given the external debt constraint, much had yet to be accomplished in Greece, Mr. Blandin concluded. The proposed program, which was aimed at tackling first the short-term imbalances in order to restore domestic and external confidence, presented an adequate step in the right direction. The staff's comments on the significant progress toward an agreement with the commercial banks and on the plans for a Paris Club meeting were encouraging. The debt discussions should give the authorities room for maneuver that should be used to strengthen the economy.

Mr. Hodgson commented that the implementation of the adjustment program would likely be difficult. The Fund must recognize the political and social implications as well as the economic effects of the authorities' recent adjustment efforts. Despite those efforts, the economic situation was unsustainable, and the strain on the economy resulting from the delay in making additional required adjustments had become increasingly intolerable for the economy and the people of the Dominican Republic. The new adjustment program provided a good basis on which to correct the imbalances in the economy and to create an environment that would permit a sustainable rate of growth in coming years. The main challenge facing the authorities was to adhere firmly to the adjustment program and to maintain adjustment in coming years.

For two reasons, the authorities must be careful not to underestimate the challenges facing the economy over the medium term, Mr. Hodgson continued. First, the program would have to be vigorously implemented to gain and keep the confidence of official lenders and commercial bank creditors, thereby enabling the Dominican Republic to obtain the debt relief and new financing that it needed to support the adjustment program. Second, the Dominican Republic would have little room for maneuver over the medium term. As the staff's medium-term scenario showed, even if the adjustment effort initiated in 1985 were sustained, balance of payments developments in the medium term were unlikely to be favorable. The debt burden was heavy, and considerable balance of payments financing would be required until at least 1988. A delicate balance must be maintained between the need to avoid exacerbating the debt burden by trying to acquire substantial amounts of new credits, and the need for financing to permit an acceptable pace of development. That balance must be achieved in part by efforts to contain domestic demand.

As his chair had noted during the 1984 Article IV consultation with the Dominican Republic, a key aspect of the economic recovery should be structural adjustments designed to shift resources to the external sector and permit an expansion of exports, Mr. Hodgson said. In that connection, one of the most striking and troubling elements of the medium-term scenario was the poor overall export performance: total export receipts were projected to grow by only 4.6 percent each year in 1985-90, even though nontraditional exports were forecast to grow at an annual rate of 19 percent. Even with a sizable increase in tourist revenues and capital flows, the projected rate of growth of export receipts would permit only slow growth of imports from the rather low level expected in 1985. In the circumstances, the authorities must maintain or improve the competitiveness of exports. Their decision in January 1985 to unify the exchange rate and to allow it to float should help to improve the country's competitive position, and should maintain the policy of permitting the exchange rate to float freely. Their decision to impose large export taxes was a cause for concern. The revenues from those taxes would help considerably to strengthen the fiscal position, but the taxes could discourage exports. The export taxes should be replaced by revenue measures that would not undermine the incentive to export, and he agreed with the staff that such measures should be a focus of the midterm review.

The World Bank's welcome involvement in the Dominican Republic could be crucial in formulating a public sector investment program that could attract support from official lenders, Mr. Hodgson commented. The World Bank's expertise could be valuable in analyzing investment alternatives that would significantly contribute to exports.

The authorities' efforts to reduce the fiscal deficit from 7.5 percent of GDP in 1984 to 4.9 percent of GDP in 1985 were welcome, even though much of the increase in revenue was to be derived from temporary export taxes that should be replaced as quickly as possible, Mr. Hodgson remarked. The increase in petroleum prices was welcome, as it accounted for a significant portion of the projected rise in government revenues. The fiscal restraint was particularly ambitious because the effective depreciation of the Dominican peso had increased recorded outlays. Accordingly, current expenditures, particularly wages, would have to be tightly controlled. The authorities had taken the strong but necessary step of deciding not to increase government wages unless the Congress passed compensatory revenue measures.

The steps being taken to increase electricity tariffs and prices of foodstuffs were also welcome, Mr. Hodgson continued. However, further adjustments should be made as necessary, so that the financial position of the public enterprises could be strengthened, thereby permitting the enterprises themselves to generate at least some of the financing for their investments.

He supported the authorities' efforts to contain the growth of liquidity and to increase the external assets of the Central Bank, Mr. Hodgson said. The emphasis on restraining credit to the public sector was particularly welcome, and he was pleased that the projected fiscal deficit was to be financed entirely by external resources. The authorities' effort to promote domestic savings by increasing interest rates and reducing the minimum denomination of savings instruments was encouraging, but additional measures were required, as real interest rates were still negative. The authorities should introduce a more flexible and responsive interest rate policy to improve the efficiency of resource allocation and increase savings.

A number of exchange restrictions and multiple exchange rate measures remained as a result of the external arrears and the taxes on exports, Mr. Hodgson noted. That situation was admittedly unavoidable in the short run and was seen as temporary by the authorities. He supported the granting of a waiver for those exchange restrictions, but he hoped that progress in eliminating them would be made by the midterm review. Finally, the proposed stand-by arrangement was acceptable.

Mr. Ismael stated that the proposed stand-by arrangement was an encouraging attempt to formulate and implement appropriate adjustment policies to tackle the domestic and external imbalances. The new program included a broad range of policy measures that should improve the prospects for sustained medium-term growth. That the authorities had already made some headway in the right direction by introducing certain measures in recent months was reassuring.

A reform of the exchange system was a major feature of the new program, Mr. Ismael observed. The authorities' decision to unify the exchange rate in January 1985 was welcome. Since then, the peso had been floating freely, and the exchange rate had been determined by market forces. Recent developments seemed to have paved the way for restoring realistic costprice relationships, thereby avoiding the distorting effects of previous exchange arrangements. The Central Bank had appropriately decided not to intervene in the foreign exchange market to influence the exchange rate. The restrictive external measures were understandable, but the authorities should be urged to eliminate them as soon as possible.

The new program included restrained fiscal and monetary policies in order to ensure that the exchange rate policy would be effective, Mr. Ismael commented. The planned reduction in the ratio of the public sector deficit to GDP from an average of 6.4 percent during the four years to 1984 to 4.9 percent in 1985 seemed reasonable, and it was to be obtained by a fairly balanced combination of revenue increases and expenditure restraint. The revenue increases were to be achieved through the implementation of discretionary tax measures that were justified by the need to recoup the windfall gains from the devaluation. He was confident that by the midterm review alternative measures would be available to replace the current temporary measures.

Stricter control of public expenditures was needed, and the authorities' commitment not to raise wages unless compensating measures were taken to increase revenues or reduce expenditures was welcome, Mr. Ismael continued. Further efforts were needed to reform the public enterprises and reduce their financial imbalances, which had contributed to the budget deficits. The steps taken by the authorities to increase electricity and food prices were in the right direction, and the authorities should be urged to adjust the prices for other subsidized commodities; in that connection, World Bank assistance would be helpful.

The authorities' efforts to ensure better control of the expansion of domestic liquidity were impressive, Mr. Ismael commented. They should be urged to pay special attention to the unhealthful activities of the Reserve Bank, a state-owned commercial bank. The Reserve Bank must adhere strictly to the timetable for the progressive elimination of its reserve deficiency if the measures to limit credit expansion were to be effective. Given the freeze on commercial bank credit to the public sector, the expansion of credit to the private sector was essential for the recovery of private sector activity, increased investment, and growth. The authorities' efforts to liberalize the issue of financial certificates by financial institutions should help to mobilize savings and to ensure efficient resource allocation.

The projected sharp reduction in the external current account from 4.3 percent of GDP in 1984 to 0.6 percent in 1985 was encouraging, especially in the light of the expected adverse movement of some 8.5 percent in the terms of trade, Mr. Ismael said. The staff's projected improvement in the balance of payments in the medium term seemed reasonable.

The external debt service burden was large, and he agreed with the staff that there was a need for caution with respect to further borrowing, Mr. Ismael remarked. The high debt service ratios expected in 1985 and 1986 were especially worrying. They underscored the country's precarious financial position, would leave little room for maneuver in the medium term, and clearly suggested the need to maintain the adjustment effort.

The World Bank's involvement in analyzing the country's medium-term prospects and the issues concerning the reform of the electricity tariff structure were particularly welcome, Mr. Ismael said. The agreement between the Fund and the Bank staffs on many aspects of the authorities' medium-term external strategy was encouraging. The World Bank was helping the authorities to formulate a public investment program that would attract stronger support from official lenders; the Bank was also accelerating the processing of two project loans that had been held in abeyance pending the adoption of adjustment policies. Those efforts should bolster the authorities' attempts to make needed adjustments and achieve sustained growth in the medium term. Finally, the proposed decisions were acceptable.

Mr. Coumbis commented that the Dominican Republic had obviously suffered from severe internal and external imbalances in recent years. During the discussion on the staff report for the 1984 Article IV consultation with the Dominican Republic (EBM/84/124, 8/8/84), Executive Directors had considered that the authorities should adopt immediately an appropriate exchange rate policy supported by firm fiscal and credit policies in order to improve the economy's general efficiency and international competitiveness. That the extended arrangement for the Dominican Republic had had to be canceled was regrettable, as valuable time had been lost and little room for maneuver was left. In the circumstances, the proposed adjustment program would have to be fully implemented. The authorities understood that the situation was critical, and the measures introduced in 1984 and early 1985 were evidence of their willingness and determination to keep the new program on track. In January 1985, the exchange system had been unified, and some controlled prices--particularly those for petroleum products and electricity tariffs--had been adjusted.

The proposed adjustment program was well designed and realistic, Mr. Coumbis considered. Its main targets and the performance criteria were adequate, the principal assumptions were reasonable, and the policy objectives were feasible. Hence, he had no difficulty in accepting the proposed stand-by arrangement and in approving the exchange restrictions and multiple currency practices.

Although the exchange rate unification had resulted in a significant increase in public sector outlays, the proposed program included a target of a reduction in the overall public sector deficit from 7.5 percent of GDP in 1984 to less than 5 percent in 1985. That target would not be easy to meet, but the authorities could take a major step toward doing so by avoiding any adjustment in public sector salaries in 1985. As to the taxes on export proceeds, he agreed with the staff that they should be replaced as soon as possible.

The medium-term scenario showed the weakness and vulnerability of the external position, Mr. Coumbis commented. The medium-term prospects for traditional exports were disappointing, and a major shift in the export strategy was called for. Given the additional financing required to close the resource gap in 1985 and 1986 and its effect on future debt service payments, there would likely be a sizable external current account deficit--equivalent to some 4 percent of GDP--even in 1989 and 1990, and the debt service ratio would be approximately 33 percent. Those prospects underscored the need for continued strong adjustment throughout the rest of the 1980s. He wondered whether the rescheduling mentioned by the staff in its opening comments was likely to change the medium-term outlook.

He was satisfied with the close, extended cooperation between the staff and the World Bank in a number of areas, such as the electricity tariff structure, the medium-term prospects of the economy, and the adjustment program, Mr. Coumbis said. The willingness of the World Bank to accelerate the processing of two loans for vocational training and highway maintenance upon the approval of the proposed adjustment program was welcome.

Mr. Clark commented that the authorities had attempted to tackle the severe external and internal imbalances in the economy in the context of an extended arrangement introduced in 1983. The expected degree of adjustment had not taken place, but the experience under that arrangement had taught some lessons that were reflected in the design of the new adjustment program.

The fact that key adjustment measures had already been implemented increased the chances for the success of the new adjustment program, Mr. Clark continued. The unification of the exchange rate and the first steps toward a more realistic pricing structure for the public enterprises were particularly important. Prior actions could often help to provide a firm basis for the implementation of a new adjustment program, but they were even more important when a previous program had been interrupted because of a failure to agree on crucial policy measures. The extent of the prior actions by the Dominican authorities warranted an immediate drawing in the first credit tranche, despite the absence of final arrangements for closing the financing gap in 1985.

In the longer run, a shift in the structural balance of the economy would be essential, especially in view of the heavy reliance on sugar and other agricultural crops and minerals whose price trends had been unfavorable, Mr. Clark said. In that connection, the World Bank would have a major role to play, and its involvement in the design of the new adjustment program was welcome. Such collaboration between the authorities and the Bank should be continued.

The scheduled second review under the proposed stand-by arrangement was to include the formulation of policies for 1986, Mr. Clark noted. Given the need to place the adjustment process on a firm track, he hoped that the new policies would lead to a further arrangement with the Fund in 1986.

Inadequacies in fiscal policy had been a significant cause of the breakdown of the extended arrangement, and strengthening public finances was an important objective under the new program, Mr. Clark said. The decline in the overall deficit of the consolidated public sector from 7.5 percent of GNP in 1984 to about 5 percent in 1985 seemed to be matched by the elimination of the exceptional operating losses of the Central Bank. A further comment on how those losses had been treated and on the underlying fiscal position would be helpful. In early 1985, the actual exchange rate had been lower than assumed in the budget forecast, and he wondered what effect that outcome had had on the deficit projections in Table 3.

Although the central government accounts were projected to move into surplus in 1985, the improvement was likely to be offset by an increase in the deficit of public enterprises, particularly the electricity industry, Mr. Clark observed. That short-term deterioration was explained partly by the investment plans of the electricity enterprises, which should help to improve their net revenue position in the long run. In addition, however, the operating surplus of public enterprises was expected to be eliminated in 1985, and interest payments were expected to increase. Apparently, those projections underscored the need for further action in the medium term if the financial position of the public enterprises were to improve.

The projected central government surplus was to arise entirely from the imposition of taxes on export receipts that were meant to be temporary, Mr. Clark observed. He wondered how reliable the forecast of the yield from such taxes could be expected to be.

The authorities intended to replace the export taxes with more durable sources of revenue, Mr. Clark continued. However, since those taxes seemed to be used largely to finance price subsidies, it might be preferable to move in the direction of phasing out both subsidies and the temporary export taxes rather than looking for more durable sources of finance; he fully recognized the political constraints on implementing such a suggestion. Although the authorities' intention not to raise public sector wages without first finding offsetting savings or additional revenues elsewhere was welcome, he wondered whether it would be achievable, given the price increases resulting from the process of price liberalization.

Real interest rates were expected to become positive in 1985, Mr. Clark noted. He wondered what rate of inflation that expectation implied for the end of 1985. The proposed interest rate flexibility to encourage domestic savings and allocate them efficiently was welcome.

The medium-term balance of payments outlook was unfavorable, Mr. Clark commented: the ratio of debt to GNP was expected to rise sharply in 1985 and to decline only moderately by 1990. Despite the recent substantial devaluation, the volume of exports in 1985 was expected to remain virtually unchanged; even by 1990, exports were expected to reach only the level of 1980. Moreover, the export forecast was based partly on rapid growth--about 20 percent per annum--of nontraditional exports. The staff should comment further on what seemed to be the rather slow pace of reductions in external arrears in coming years.

Despite the substantial actions already taken by the authorities, the balance of payments position was expected to remain fragile in the medium term, and there was clearly no room for slippage in the implementation of the new adjustment program, Mr. Clark concluded. The authorities should be urged to remain firm in implementing adjustment measures in the face of significant political pressure to adopt less stringent measures.

Mr. Grosche commented that the staff paper showed that inappropriate economic policies maintained over a number of years had been the major cause of the severe external and internal imbalances in the economy. Insufficient adjustment and delays in formulating a program for 1984 under the recently canceled extended arrangement had kept the authorities from tackling the problems at an earlier stage.

He was pleased that the authorities were in a position to adopt with determination the necessary adjustment measures, Mr. Grosche went on. That some of the required adjustment measures--including the overdue reform of the exchange rate system--had already been introduced was particularly encouraging. Those measures should help the authorities to meet the ambitious adjustment targets, particularly those for the external economy. Given the authorities' apparent determination to tackle the serious imbalances in the economy, their comprehensive adjustment efforts appeared to deserve the Fund's financial support, and the proposed decision should be approved. In supporting the decision, he assumed that there was a reasonable assurance that adequate debt relief would be provided to close the financing gap projected for 1985. The opening comments on that matter by Mr. Arias and the staff had been helpful.

He fully endorsed the staff's recommendations concerning the necessary course of action in the coming period, Mr. Grosche continued. The export taxes should be seen as a temporary measure; other revenue measures to reduce the budget deficit should be found soon.

Given the large size of the external and internal imbalances, the financing gaps projected through at least 1988, and the large external debt, the authorities must sustain their adjustment effort and, if necessary, accelerate it, Mr. Grosche considered. It was particularly important to maintain a flexible exchange rate policy to ensure that the external targets would be met. In addition, a major review of the medium-term external strategy was called for. Projected earnings by the traditional export sector were not promising, and a strong emphasis on nontraditional exports and tourism was required. Finally, the proposed approval of the exchange restrictions and multiple currency practices was acceptable.

Ms. Lundsager commented that, beginning with the exchange rate unification and certain price adjustments earlier in 1985, the authorities had implemented several significant adjustment measures aimed at reducing internal and external imbalances in the economy. The expected improvement in the external current account deficit, from 4.3 percent of GDP in 1984 to 0.6 percent in 1985, and the reduction in the consolidated public sector deficit from 7.5 percent of GDP in 1984 to 4.9 percent in 1985 would establish a sound basis for the continued adjustment required over the medium term. Given the authorities' commitment to the adjustment effort, their request for a stand-by arrangement was acceptable. The staff's opening statement had reduced her reservations about the financing of the program, but she continued to harbor some doubts about the appropriateness of the proposed access and the phasing of purchases.

The exchange rate unification in January 1985 and the cumulative depreciation since then were particularly welcome, as they would contain the demand for imports while encouraging the longer-term diversification of exports into nontraditional sectors where the prospects for growth were particularly favorable, Ms. Lundsager said. That the exchange market appeared to have been functioning in an orderly fashion since January 1985 and without any sign of government intervention was reassuring. However, the Government could affect the exchange rate by not making purchases of foreign exchange to cover public sector imports. For that reason, the authorities should be urged to avoid running down their inventories of imported goods to such low levels that single large purchases of foreign exchange would become necessary, thereby possibly causing large fluctuations in the exchange rate.

The temporary tax on traditional and nontraditional exports was a cause for concern, Ms. Lundsager continued. She understood the need for more revenue and the ease with which a windfall profits tax on exports could be applied, but measures intended to be temporary often became permanent, and, in many countries, export taxes had caused a decline in exports and even disinvestment by foreign firms. To avoid such serious consequences, the authorities should eliminate the tax on nontraditional exports immediately and replace the tax on traditional exports by other budgetary measures at the time of the midterm review.

Table 13 showed that the export surcharge was expected to yield significant revenues in 1985, Ms. Lundsager noted. Indeed, those revenues were expected to exceed central government spending on salaries, goods, and services. Given the importance of eliminating the export taxes, the authorities should begin thinking forthwith about alternative budgetary measures to compensate for the elimination of those taxes.

Transfers to public enterprises had become substantial following the exchange rate adjustments and were due largely to external debt obligations of the public sector, Ms. Lundsager went on. The data suggested that further price adjustments might be required, especially by the Price Stabilization Institute. She wondered whether the new program provided for automatic price increases following exchange rate changes. Such price measures were important not only for budgetary reasons, but also to encourage production of import substitutes. She recognized the difficulty in increasing prices, and the staff should comment further on alternative measures as well as the potential for eliminating subsidies and transfers. The World Bank's extensive assistance in the reform of the public enterprises, particularly the electric company, was welcome. She wondered whether there was any chance for the Dominican Republic to receive a structural adjustment loan at some time in the future.

Monetary policy apparently was appropriately tight, and credit expansion in 1985 was to be restrained, Ms. Lundsager noted. While the negative real interest rates might not be problematic for the time being, the authorities should be urged to increase them if the rate of inflation did not fall as quickly as expected or if capital flows became unfavorable. The staff had projected "other" capital flows of negative $19 million, and she wondered whether higher interest rates would help to strengthen that item.

Because of the expected heavy debt service burden, the medium-term outlook was unfavorable, Ms. Lundsager remarked. Current account adjustment might well prove difficult after 1985, thereby leaving significant financing gaps. Creditors probably would be favorably disposed toward debt rescheduling if a strong adjustment effort were maintained. That probability underscored the importance of the second scheduled review under the new stand-by arrangement. During the review, the economic and financial policy mix planned for 1986 would be assessed, even though the final performance criteria test date would be end-December 1985.

The discussion on page 13 raised some questions about the financing gap as well as the adequacy of debt relief and potential new funds from commercial banks, Ms. Lundsager commented. The additional developments described by the staff in its opening statement were welcome; she would have felt uneasy endorsing an adjustment effort that could have been placed in jeopardy at an early stage because the available financing was inadequate.

Given the medium-term outlook for the economy, she would have preferred a somewhat smaller degree of access to Fund resources than the staff had proposed, Ms. Lundsager said. The Dominican Republic faced a long-term debt problem, and large amounts of Fund financing might increase the authorities' difficulty in achieving a manageable long-term debt profile. The justification for the large first purchase under the new stand-by arrangement was not fully satisfactory, even though the authorities had already introduced significant adjustment measures. Permitting them to use the first credit tranche, even though the country's total use of Fund resources was already equivalent to 200 percent of quota, seemed somewhat inappropriate, even if technically permissible. Finally, she supported the proposed decisions but accepted the approval of the exchange restrictions only reluctantly, given her reservations about the appropriateness of the export taxes and the resulting multiple currency practice.

Mr. Pérez stated that the proposed stand-by arrangement was acceptable. The Dominican Republic provided a clear example of the severity of the economic imbalances remaining in some small countries and of the high cost for such countries of regaining a viable payments position. The Dominican authorities' intention to implement sound measures was encouraging, particularly in view of the public resistance to similar measures in the past. Indeed, the authorities had already made the most important policy decisions; in most cases, a member agreed to adopt significant adjustment measures only after it had gained Fund approval of a stand-by arrangement. The recent actions by the Dominican authorities clearly showed their firm determination to bring the economy back on track.

The reunification of the exchange rate system was probably the most important step recently taken by the authorities, Mr. Pérez considered. The dual exchange system had been a cause of imbalances and subsidies for many years. The authorities should be encouraged to maintain exchange rate uniformity, the first step in correcting the external and internal imbalances.

The main challenges to the authorities in the medium term would probably come from the external sector, Mr. Pérez remarked. The country's considerable dependence on traditional exports gave it little flexibility to reallocate resources in order to avoid the negative effects of unfavorable international prices. As a result, recent price trends had seriously limited the possibility for a good trade performance; and the commodity prices projected for the coming period suggested that the value of traditional exports was unlikely to increase soon. Accordingly, the authorities should attempt to diversify exports. The staff had recommended that they give greater emphasis to nontraditional raw and processed agricultural exports; further comment on the feasibility of diversifying exports within the current structure of the economy would be helpful.

At the same time, revenues from tourism had performed well, offsetting much of the adverse effect of the performance of other items in the trade balance, Mr. Pérez went on. Tourist receipts should make a major contribution to the effort to balance the external accounts, but certain factors should be borne in mind in order to exploit fully the possibility for increasing those receipts. Competition for tourists in the region was increasing, and it would be difficult for the Dominican Republic to increase its tourist revenues by competing directly with neighboring countries. In addition, the tourist industry required considerable infrastructural support, and the authorities would have to encourage foreign direct investment.

The short-term external debt position seemed fragile, and the staff's opening statement that there should be no difficulty in financing the US$336 million financing gap was welcome, Mr. Pérez said. External policy should be aimed at achieving and sustaining an external current account surplus, and, in that connection, diversifying exports and promoting tourism were of paramount importance.

The authorities were to be commended for the measures recently introduced to cope with the public sector deficit, Mr. Pérez considered. The financing role of the Central Bank had been excessive, and the recent imposition of an export tax was a step in the right direction, as it should help to reduce the public sector borrowing requirement. However, he was worried that the effects of export taxes might prove temporary. After all, two thirds of the revenue increase projected for 1985 would be due to the export tax, which was a useful instrument to finance the fiscal gap in the very short run but would not meet the basic structural need for a more broadly based tax system. The staff should comment further on the authorities' plans for replacing the current tax measures and for implementing a substantial tax reform to regulate public sector revenue properly.

The investment plans for public enterprises, designed to reduce the enterprises' energy requirement, were appropriate, Mr. Pérez said. The planned sizable expenditure on capital formation would undoubtedly prove beneficial in the medium term; the favorable effect of the effort to adjust public enterprises' price schedules was likely to be complemented by the recent unification of the exchange rate.

Finally, the restrictive monetary policy that the authorities intended to maintain under the new program was appropriate, Mr. Pérez commented. It would be consistent with the recently adopted exchange rate measure. The steps to control the expansion of domestic credit were also appropriate. The Government was clearly committed to bringing the economy onto a sustainable growth path, and the proposed stand-by arrangement would support its efforts.

Mr. Polak said that he was pleased that the authorities had adopted an adjustment program that had a reasonable chance of restoring balance and growth, which had been lacking in the wake of the various partial measures adopted since the autumn of 1982, including measures under the extended arrangement initiated in January 1983. After the extended arrangement had gone off track, the authorities' policy approach had been hesitant. The exchange rate measures adopted in January 1985--which had eliminated the last vestiges of parity for the peso with the U.S. dollar--together with the fiscal and monetary measures adopted at that time seemed to have provided the breakthrough that had led to the formulation of the proposed stabilization program.

The fiscal approach in the short run, including the heavy reliance on export taxes, was far from being optimal, Mr. Polak continued. Given the low proportion of normal government revenues in GDP--about 15 percent--the authorities should be able to find other sources of revenues. However, it was essential to ensure that the export taxes would be temporary. The fiscal approach also appropriately provided for the public sector to avoid using domestic bank financing for other than strictly seasonal purposes.

The freeing of the exchange rate should stimulate nontraditional exports, thereby helping to minimize the external current account deficit, Mr. Polak commented. Still, the medium-term financing and external outlook was difficult despite the expected sharp increase in nontraditional exports and in tourism. Debt relief would be needed in coming years, as the debt ratios were projected to remain high through at least 1990. The apparent agreement by the commercial banks to a five-year rescheduling arrangement was a hopeful sign. The staff should comment on understandings that might have been reached about the relations between the Dominican Republic and the Fund during the final four years of the proposed five-year rescheduling period.

Given the medium-term outlook for the country, the proposed stand-by arrangement was unlikely to be the last, Mr. Polak said. In providing a conventional justification for the proposed access of 70 percent of quota, the staff had noted that the country had a large balance of payments need and was making a strong adjustment effort. He did not question those conclusions, but the Dominican Republic's debt to the Fund was already fairly large, and it was his impression that in recent similar cases, particularly those involving African countries, access had typically been 50-60 percent of quota. A more detailed explanation of the proposed access for the Dominican Republic would be helpful. Finally, the proposed decisions were acceptable.

Mr. Taha said that, given the serious economic and financial problems facing the Dominican Republic, the authorities' renewed adjustment initiative was welcome. The program objectives were realistic, and the policy measures needed to achieve them were appropriate; indeed, many of them had already been implemented, and the staff's comments on the progress the authorities had already made were encouraging. The proposed decisions were acceptable.

The authorities were appropriately seeking to reduce the external and internal imbalances to create an environment conducive to noninflationary growth, Mr. Taha continued. However, the measures introduced to correct cost-price relationships in the economy would make it difficult to achieve a significant reduction in the rate of domestic inflation in the short run. It was essential for the authorities to contain inflationary pressures in the immediate future and to take appropriate steps to reduce the rate of inflation over the medium term. To that end, they should maintain restrained fiscal and monetary policies, which, together with the recently adopted exchange rate policy, should strengthen the external payments position.

The authorities had implemented several measures designed to reduce the overall public sector deficit to less than 5 percent of GDP in 1985, Mr. Taha noted. While most of the measures needed to achieve that target had already been introduced, he agreed with the staff and Mr. Arias that expenditure control should not be relaxed. He also agreed with previous speakers that the authorities might need to consider more lasting reforms to sustain the viability and strength of public finances in the medium term. They should maintain their commendable efforts to strengthen the finances of the public enterprises with the continued cooperation of the World Bank.

The authorities' efforts to improve the financial performance of the Central Bank and their cautious credit policy were appropriate, Mr. Taha said. The measures implemented to control domestic liquidity, encourage savings, and meet the private sector's demand for credit were welcome. The authorities had appropriately decided that credit expansion to the public sector should be limited to meeting essential seasonal requirements.

In the effort to reduce the external payments imbalance and improve the medium-term outlook for the economy, the flexible exchange rate policy would play a crucial role, Mr. Taha considered. If the external balance were to be manageable over the medium term, the adjustment effort would have to be sustained and, if necessary, strengthened. In that connection, the limits on commercial borrowing under the new program were fully appropriate.

The staff representative from the Western Hemisphere Department said that, in preparing the paper on a request for a stand-by arrangement, the staff had made implicit assumptions about the terms of the rescheduling by commercial banks and official creditors. The latest available information suggested that, in the years after 1985, the terms would actually be more favorable than the staff had expected. Accordingly, the ratios in Table 8 for 1986-90 were likely to prove to be somewhat on the high side.

It was difficult to compare fiscal performance in 1984 and 1985 because of the exchange rate action in January 1985, the staff representative remarked. On balance, the overall fiscal position as measured by the ratio of the fiscal deficit to GDP in 1985 probably would not change significantly in comparison with 1984 if an adjustment were made to exclude the losses incurred by the Central Bank in 1984, which were not expected to recur in 1985. The deficit of the public enterprises in 1985 would be higher than in 1984 largely because, since the exchange rate adjustment, enterprises had had to pay for many items at actual market costs; they had previously enjoyed the benefits of a greatly overvalued exchange rate.

The adjustment of the exchange rate had directly affected the operating costs of public enterprises; prior to the January 1985 exchange rate adjustment, the implicit costs of the overvalued exchange rate had not been visible.

The staff felt that the estimates of revenues from the 36 percent levy on traditional exports and the 5 percent levy on nontraditional exports were likely to be accurate, mainly because the levies were collected by the Central Bank when export proceeds were surrendered to it, the staff representative said. The staff had had considerable success in predicting export receipts in previous years.

It was true that, on the basis of the projected annual rate of inflation, real interest rates were negative, the staff representative commented. However, the staff believed that, in January-March 1985, the rate of inflation had reflected the adjustment measures introduced by the authorities, and that the monthly rate would decline significantly over the year; by midyear the rate of return on financial assets on a monthly basis was projected to be positive, and it was expected to become increasingly positive in the second half of 1985.

Many of the transfers to public enterprises were designed to compensate for part of the additional costs that the enterprises had incurred because of the exchange rate adjustment in January 1985, the staff representative explained. It was of course possible that the transfers would eventually be reduced as a result of further price adjustments by the enterprises, and, if necessary, the staff would review the question of further price increases with the authorities during one of the scheduled reviews under the new stand-by arrangement. At present, however, the program did not provide for automatic adjustments in prices to reflect actual costs. Nevertheless, the Electricity Corporation was expected to make monthly adjustments in its tariff rates as long as it continued to incur an operating loss.

External arrears had amounted to US$500 million at end-1984, the staff representative noted. The new program provided for approximately US$90 million of those arrears to be liquidated through cash payments in 1985. It was expected that the debt rescheduling by the commercial banks and official creditors would eliminate approximately a further US$300 million of the external arrears, and that by the end of 1985 the arrears would not exceed more than some US$110 million.

The medium-term prospects for the country's traditional exports were poor, and the situation would become even more difficult in 1989, when gold deposits were exhausted and gold exports ceased, the staff representative said. Until then, receipts from gold exports would probably continue to generate approximately US$100 million annually.

Debt rescheduling negotiations between the commercial banks and the Dominican Republic had not yet been completed, and it would be premature to draw final conclusions on the likely relationship between the Fund and the Dominican Republic during the period covered by the rescheduling, the staff representative from the Western Hemisphere Department remarked. However, it was the staff's understanding that the commercial banks were asking the authorities to maintain a relationship in the upper credit tranches during the entire period covered by the rescheduling.

The Deputy Director of the Exchange and Trade Relations Department commented that, in addition to the factors that Mr. Polak had mentioned--the magnitude of the payments need and the strength of the adjustment effort--the proposed access took into account the fact that the Dominican Republic had not been a heavy user of Fund resources. The recently canceled extended arrangement had been the only arrangement for the Dominican Republic in the previous 20 years, and the Dominican Republic's outstanding use of Fund resources was not unduly large in comparison with that of other member countries. In that context, it should be noted that the data on Fund credit to the Dominican Republic on page 25 of EBS/85/75 included a buffer stock purchase in respect of which a repurchase had recently been made. Accordingly, on the basis of the usual criteria on individual country access, particularly past use of Fund resources and the strength of the adjustment measures--including prior actions--of the member requesting an arrangement, access on the proposed scale was warranted for the Dominican Republic. The staff had carefully considered the issue of access, particularly in view of the country's possible need for further arrangements with the Fund in coming years. An important argument in favor of the proposed access was that it would be appropriate for a member with limited international reserves, even though it had begun its adjustment effort by making a sizable adjustment in the exchange rate to have at its disposal a reasonable amount of liquidity in support of its efforts.

On the phasing of the proposed purchases, the Deputy Director noted that the extended arrangement floated above the first credit tranche. As a consequence, the authorities had made purchases under the extended arrangement but had left the first credit tranche unused. Accordingly, the first tranche would automatically become available to the authorities upon the Executive Board's approval of the proposed stand-by arrangement. As access to the first credit tranche could not be phased, the first purchase under the proposed stand-by arrangement was relatively large. The staff had borne in mind the desirability of spreading out the purchases over the full period of the new stand-by arrangement; largely for that reason, the staff had proposed holding a second review under the arrangement, rather than limiting the number to a single midterm review. The final purchase under the proposed stand-by arrangement therefore would be based not only on performance as of end-December 1985, but also on the assessment of the authorities' policies for all of 1986; it would not be based merely on January through mid-April 1986, the months of that year covered by the stand-by arrangement.

The staff representative from the Western Hemisphere Department commented that the Fund staff had been discussing with the World Bank staff the various kinds of assistance that the World Bank planned to make available to the Dominican Republic in the coming period. At present, a major World Bank mission was visiting the Dominican Republic to study those options. The Fund staff would have a better idea of the likely World Bank assistance after the Bank mission had submitted its report.

The Chairman remarked that at first glance access of, say, 60 percent of quota might seem appropriate for the Dominican Republic. However, it was important to remember that the authorities had been given access equivalent to 450 percent of quota over three years under the extended arrangement on the basis of the old quota. The amount of access that the staff had originally proposed for the authorities' consideration had been difficult for the authorities to accept in the light of recent developments in the country, including the introduction of courageous measures despite significant domestic disturbances. The recommendation of a particular amount of access was a matter of judgment, and the staff and management had finally settled on the proposed 70 percent of quota as being appropriate to the present circumstances of the Dominican Republic.

Mr. Arias said that there seemed to be broad agreement that the authorities' economic measures were important and courageous and also reflected their willingness to restore confidence and re-establish the conditions needed to achieve substantial economic growth. The authorities were strongly determined to maintain appropriate policies in order to ensure that the new program would be fully implemented.

The Executive Board then took the following decisions:

Stand-By Arrangement

1. The Government of the Dominican Republic has requested a stand-by arrangement for the period April 15, 1985-April 14, 1986 for an amount equivalent to SDR 78.5 million.

2. The Fund approves the stand-by arrangement set forth in EBS/85/75, Supplement 1 and waives the limitation in Article V, Section 3(b)(iii).

Decision No. 7951-(85/59), adopted
April 15, 1985

Exchange System

The Dominican Republic retains restrictions on payments and transfers for current international transactions and multiple currency practices as described in EBS/85/76. In the light of the implementation by the Dominican Republic of policies for balance of payments adjustment, which are supported by a stand-by arrangement (EBS/85/75), the Fund grants approval for the retention of these restrictions and multiple currency practices until the conclusion of the 1985 Article IV consultation, or August 15, 1985, whichever is earlier.

Decision No. 7952-(85/59), adopted
April 15, 1985

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/85/58 (4/12/85) and EBM/85/59 (4/15/85).

2. EXECUTIVE BOARD - REPRESENTATION EXPENSES

The Executive Board approves the recommendation concerning representation expenses incurred at the time of Interim and Development Committee meetings in Washington not held in conjunction with Annual Meetings, as set forth in EBAP/85/96 (4/11/85).

Adopted April 12, 1985

APPROVED: February 7, 1986

LEO VAN HOUTVEN
Secretary