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Minutes of Executive Board Meeting 85/68

3:00 p.m., May 1, 1985

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	A. K. Diaby, Temporary
	E. L. Walker, Temporary
	P. Péterfalvy, Temporary
	G. E. L. Nguyen, Temporary
	A. Mustafa, Temporary
	M. Sugita
	B. Goos
	T. Sirivedhin, Temporary
	L. Leonard
	G. D. Hodgson, Temporary
A. Kafka	J. Hospedales, Temporary
	H. Fugmann
	W. K. Parmena, Temporary
	M. A. Weitz, Temporary
	J. E. Suraisry
	G. R. Castellanos, Temporary
J. J. Polak	J. de Beaufort Wijnholds
	A. V. Romuáldez
G. Salehkhou	
	A. S. Jayawardena
N. Wicks	T. A. Clark
	I. Angeloni, Temporary
Zhang Z.	

J. W. Lang, Jr., Acting Secretary
S. J. Fennell, Assistant

Also Present

European Department: H. B. Junz, K.-W. Riechel, J. S. Van't dack. Exchange and Trade Relations Department: J. T. Boorman, S. Kanesa-Thasan. Fiscal Affairs Department: G. Blöndal, P. Kohnert. Legal Department: J. K. Oh. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; S. N. Kimaro, C. M. Loser, S. C. de Sosa. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: A. A. Agah, K. A. Hansen, H.-S. Lee, G. W. K. Pickering, D. C. Templeman, A. Vasudevan. Assistants to Executive Directors: J. R. N. Almeida, W.-R. Bengs, G. Biron, R. Fox, V. Govindarajan, K. Murakami, D. J. Robinson, A. A. Scholten.

1. NETHERLANDS - 1985 ARTICLE IV CONSULTATION

The Executive Directors continued from the previous meeting (EBM/85/67, 5/1/85) their consideration of the staff report for the 1985 Article IV consultation with the Netherlands (SM/85/104, 4/10/85). They also had before them a report on recent economic developments in the Netherlands (SM/85/110, 4/17/85).

The Chairman made the following summing up:

Directors welcomed the improvements that had taken place in the Dutch economy in 1984, in particular, the renewed and broadening expansion of domestic activity and the stabilization of employment, following years of declining job opportunities and sharply rising unemployment. The recent strengthening of enterprise investment, supported by the continuing restoration of profitability, and the attendant rise in consumer confidence were encouraging elements of the economic recovery in the Netherlands. As a result, the recovery appeared to be increasingly firmly based, and projections for 1985 thus indicated a further strengthening of activity.

Directors commended the Dutch authorities for pursuing domestic policies that had allowed the economy to take advantage of the external stimulus forthcoming from the pickup in world trade. Significant progress toward a number of macroeconomic goals had thereby been made. Wage moderation in the recent past had served the purpose of improving competitiveness and profitability of Dutch industry. Price stability had largely been restored, which was a notable achievement. Steps had been taken to turn back the rise in regulations. Last but not least, a program of fiscal consolidation had been pursued with renewed determination since late 1982 and had borne the first visible fruits of success in 1984.

Directors noted, however, that these early successes should be no cause for complacency. Cyclical factors had a significant hand in achieving the reduction in the fiscal deficits realized in 1984 and projected for 1985. Meanwhile, fiscal policy continued to be plagued by overruns in particular categories of expenditures, as well as by delays in implementing proposed measures. Indicative of the difficulties encountered in reducing the Government's claims on domestic resources, the share of public expenditures, in particular, those of the Central Government, had remained above their level in the early 1980s and above corresponding levels in most other industrial countries.

Directors saw no alternative to the continuation and, in the view of a number of Directors, the intensification of the adjustment strategy. They stressed that sustained and balanced economic growth required a steady reduction in the size of the public sector. Directors generally agreed with the priority given to reducing public sector expenditure and the overall fiscal deficit. While the fiscal burden was perceived to be too high generally, and marginal taxes to be so high as to constitute economic disincentives so that tax cuts accompanied by expenditure cuts would appear to offer an attractive policy option, many Directors emphasized that with the prevailing high interest rates, the continuation of large public sector deficits could easily become unsustainable. Thus, the need for, and urgency of, additional comprehensive cuts in expenditure were stressed by many Directors who singled out the open-ended current expenditure categories and the civil service payroll. They advocated early implementation of the proposed reforms of the social security system and of changes in the provision of income-related transfers, such as rent subsidies, as an effective means of reducing the burden of the public sector on the economy.

Such adjustments in the Government's policy with regard to transfers would be all the more important, as they would help deal with the acute problem of distortions in the labor market. First, through their impact on the growth of public expenditures, they would help correct the worrisome interaction between the size of the public sector and the imbalances in the labor market. Second, these measures would help stop the continuous compression of the wage scale and thus reduce the disincentives to seeking active and/or more productive employment. Directors noted, however, that these measures would fall short of the objective of increasing flexibility in the labor market and reducing unemployment if they were not supplemented by moves toward greater wage differentiation, in line with the ability to pay of individual industries and enterprises, including the public sector. Directors stressed that the same principle should apply to labor time reduction, so as to prevent the process of reducing working time from being counterproductive by adding further rigidities to the already substantial regulatory impediments in the product and labor markets. More generally, they expressed doubts that further moves toward work sharing could provide a basic solution to the unemployment problem. Several Directors also expressed their concern about the current relatively high wage claims which were clearly counterproductive in a situation of worryingly high direct and indirect labor costs and unemployment and given the paramount need to stimulate investment by enterprises and to raise business confidence.

A number of Directors noted that the rapid growth of liquidity in the economy had the potential of creating inflationary pressures in the future and recommended measures to reduce the monetary impact of fiscal deficits--apart from the obvious solution of deficit reduction--through appropriate debt management techniques. However, most Directors expressed skepticism regarding the success of an "operation twist" type debt management approach. Directors also noted the large impact of current account surpluses, recorded in recent years and expected in the near future, on domestic liquidity. They noted the policy objective of maintaining the exchange rate of the guilder unchanged vis-à-vis the deutsche mark and were interested in the discussion in the Netherlands of the case for an appreciation of the guilder. In view of the large liquidity impact of the current account and the positive interest differential with Germany, several Directors saw merit in an appreciation of the guilder vis-à-vis its partners in the European Monetary System. It was generally agreed, however, that such a move could not be made unilaterally and in no way could substitute for the determined pursuit of appropriate internal policies.

Finally, Directors commended the Dutch authorities for their firm adherence to a free trading system and for maintaining, in spite of their efforts to cut fiscal expenditures, a high level of official development assistance.

It is expected that the next Article IV consultation with the Netherlands, which is subject to the 12-month cycle, will be held before the end of the present year.

2. TRINIDAD AND TOBAGO - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Trinidad and Tobago (SM/85/92, 3/29/85; and Cor. 1, 4/15/85). They also had before them a report on recent economic developments in Trinidad and Tobago (SM/85/105, 4/15/85).

The staff representative from the Western Hemisphere Department stated that the Executive Directors of the World Bank had taken a decision on February 23, 1984 to graduate Trinidad and Tobago from Bank lending without a phase-out period because its per capita income had been twice the prevailing benchmark figure and its potential access to the capital markets was relatively favorable. However, Trinidad and Tobago was entitled to one man-year of nonreimbursable technical assistance. The Government of Trinidad and Tobago did not agree with the decision of the World Bank, particularly as it had been reached at a time when the state of the economy had been deteriorating.

The Government of Trinidad and Tobago had recently reached an agreement to purchase the refinery and certain assets belonging to Texaco, the staff representative from the Western Hemisphere Department indicated. The settlement for the purchase included a down payment of US$98 million. On the basis of preliminary information, net official international reserves had declined further by about US$310 million during the first quarter of 1985, including the effect of that transaction.

Mr. Hospedales made the following statement:

My authorities consider the staff report a reasonably balanced and comprehensive analysis of the economic situation in Trinidad and Tobago, though there are differences of emphasis in the perception of certain policy issues. Trinidad and Tobago embarked on its own program of adjustment in 1982 and, as the staff report demonstrates, this self-imposed program is beginning to show positive results in terms of re-establishing a sustainable balance in resource use while containing the rate of inflation.

Trinidad and Tobago, being an oil exporting country, seized the opportunity to accumulate considerable fiscal surpluses and foreign exchange reserves, while undertaking sustainable public expenditures--both current and, more important, capital--in the period 1974-81. The fall in oil prices together with a secular decline in crude oil production and the demise of its export refinery activities have confronted the country with a serious challenge in recent years. Initially, in 1982 and 1983, this challenge was met by the drawdown of fiscal surpluses which permitted the Government to sustain a high level of expenditure, thereby enabling the non-oil sector in the economy to continue growing at a positive rate.

However, by the end of 1983 the accumulated government savings, which had peaked at TT$5,428 million two years earlier, were virtually exhausted, and foreign reserves had declined to TT$4,886.6 million or 9.8 months' imports at the end of 1983. Accordingly, the Government recognized the need to redouble its fiscal effort and to reinforce that effort with monetary and other policies intended to bring about a sustainable balance of payments position over time, while cushioning the effect through controlled utilization of accumulated foreign reserves.

The fiscal policy mix basically included: increases in indirect taxes; increases in utility tariffs; reduction in capital expenditure; and tight control of recurrent expenditure. The cumulative effect of these measures has resulted in a reduction of the overall fiscal deficit from 15.5 percent of GDP in 1982 to 7.3 percent in 1984. Throughout, the current account has been in surplus.

The improvement in the fiscal balance has contributed both directly and indirectly to a similar trend in the balance of payments. The cut in public sector capital expenditure has been a major contributor to the reduction of imports in capital goods, a category of imports which fell by 70 percent in 1983-84. The general mix of fiscal, monetary, and other policies resulted in a reduction of effective demand such that merchandise imports fell by 26 percent in 1984 and the trade balance moved from a deficit of US$469 million in 1983 to a surplus of US$209 million in 1984--a positive swing of US$678 million. A measure of the stringency of monetary policy is the fact that the money supply fell in each of the past two years and credit expansion averaged 12.0 percent in 1983-84 compared with 21.4 percent in 1981-82.

The overall balance of payments has shown substantial, though declining, deficits in each of the past two years. My authorities are firmly committed to bringing the balance of payments into a sustainable position while maintaining the foreign reserves at a comfortable level. It is important to note that despite the loss of 62 percent of the reserves over the three-year period 1982-84, at the end of the latter year the cover was still equivalent to 8.6 months.

An adjustment program which focuses exclusively on the *containment of effective demand is inappropriate to the circum-*stances of Trinidad and Tobago, particularly in the context of a labor force that has been growing at 2.2 percent a year in 1981-84. Already the rate of unemployment has risen from 10.4 percent in 1981 to 12.8 percent in 1984. For this reason, my authorities have begun to implement a series of measures designed to stimulate investment and encourage nontraditional exports. These measures include a reduction in the level of taxation of oil companies; fiscal allowances in respect of the modernization of industrial plant and equipment; and institutional development, particularly the creation of an Export Development Corporation whose mission is the identification and aggressive exploitation of export operations in conjunction with the private sector.

My authorities are encouraged by the increase in oil production, modest as it is, which started in 1984, and by the plans announced by certain oil companies for major investment expenditures over the next five years. Additionally, several commercial investments undertaken by the Government since the latter part of the 1970s have begun to realize significant export earnings in the wider world market, particularly for ammonia and its products.

Significant progress has been made so far by Trinidad and Tobago in its effort to absorb the loss of real income occasioned by the loss of oil revenue, while at the same time ensuring a fair distribution of income. This process has been facilitated by the availability of savings accumulated in the years of economic boom and by the capacity to borrow as underlined by the fact that even now the external debt is only 18.6 percent of GDP and the external debt service ratio is 13.5 percent. My authorities consider 1985 to be the most crucial year of the adjustment process. Accordingly, they stand ready to introduce whatever further measures are necessary, particularly in budgetary expenditures, to ensure continued improvements during 1985 in key aggregates such as the current fiscal surplus, and the overall fiscal and balance of payments deficits. In this connection, the overall fiscal deficit and the balance of payments deficit, as a percentage of GDP, are expected to be reduced in 1985 to 5.5 percent and 3.3 percent, respectively.

In this context, let me take the opportunity to explain the attitude of the Trinidad and Tobago authorities to the exchange rate. This is seen as simply yet another policy instrument, but one whose effectiveness in a small open economy is contingent on restraint in price and wage increases. There are certain institutional constraints in respect of the latter since wage increases may ultimately be determined in a legal forum that is not constitutionally bound by economic criteria. In the meantime, demand management restraint continues and other nonexchange rate measures have been implemented to stimulate investment and exports. Since my authorities consider an effective incomes policy to be a necessary condition for successful use of the exchange rate in the policy mix, and incomes policy generally requires careful preparation, they are convinced that conditions are not appropriate to use this instrument at the present time.

Mr. Weitz noted that Trinidad and Tobago, a small open economy, had been severely affected by external shocks during the past few years. The drop in oil prices, limited access to the markets of the industrial countries, and economic difficulties in the countries of the Caribbean Community (CARICOM) had damaged the country's economic performance.

Aggregate domestic expenditure had been reduced through the implementation of appropriate adjustment measures, particularly through a reduction in the public deficit, Mr. Weitz observed. However, supply-side policies aimed at improving output and employment were also urgently needed. The decline in public investment might undermine the country's ability to undertake a restructuring of the productive base that was necessary to compensate for the fall in revenues from petroleum exports.

GDP and investment had declined sharply in 1983 and 1984, Mr. Weitz noted. He urged the authorities to pursue cautious monetary and credit policies in order to avoid additional deflationary pressures on private investment and the economy as a whole. Why had interest rates on deposits remained negative in real terms and below U.S. interest rates even though they were determined without intervention by the Central Bank? While the staff's medium-term projections were welcome, a sensitivity analysis might have been useful given the uncertain outlook for petroleum prices and the importance of petroleum, which accounted for 90 percent of exports, 50 percent of central government revenues, and 25 percent of GDP.

The external position of Trinidad and Tobago did not seem weak, Mr. Weitz remarked. International reserves had been equivalent to 8 months of imports at the end of 1984, the trade balance had moved from a deficit to a surplus, and the country had broad access to international capital markets through medium-term syndicated loans and bond placements. The real effective exchange rate had appreciated in recent years. The export performance of the non-oil sector had improved and the current account deficit had been reduced in 1984. That improvement on the external side was projected to continue in the medium term. Given the institutional constraints on wage increases to which Mr. Hospedales had referred, he shared the authorities' concern that an exchange rate devaluation might encourage inflationary pressures. The maintenance and expansion of export promotion and diversification measures seemed appropriate.

Mr. Hodgson noted that the past two years had been difficult for Trinidad and Tobago, which had experienced a significant decline in GNP, continued inflation, and considerable pressure on the balance of payments. Official reserves had declined by US$1.5 billion since 1982, a development that would have been catastrophic for many other small-island economies without Trinidad and Tobago's strong petroleum sector. Nevertheless, such a rate of decline in reserves could not be tolerated much longer. The authorities had recognized that the softening of world petroleum markets was not likely to be temporary, and they had begun to take some, although unfortunately not all, of the steps necessary to restore internal and external balance.

The authorities had made commendable efforts in 1984 to cut the fiscal deficit in half to 7.5 percent of GNP, Mr. Hodgson observed. All the adjustment had taken place on the expenditure side, through cuts in capital expenditure and reductions in subsidies and transfers. Further measures would be needed in 1985, and he welcomed the authorities' intention to broaden the revenue base, restrain expenditure further, and improve the financial position of the parastatals through price increases and improved efficiency. Nevertheless, he agreed with the staff that the target deficit of 5 percent in 1985 might be optimistic. Therefore, the authorities should begin without further delay to seek ways of compressing expenditures, especially if public sector wages increased by an amount greater than the Government's current wage offer. Capital outlays had already been cut, so that ways to reduce current expenditures should be examined carefully. Further improvements in the tax system, such as the introduction of a general sales tax, could also be considered.

On monetary policy, he agreed with the staff that domestic savings should be strengthened and that a review of interest rate policy would be appropriate, Mr. Hodgson commented. While savings were, in part, related to economic growth, negative real interest rates provided no incentive to saving. The existing guidelines on credit policy should be maintained, although credit growth should be moderated as the fiscal deficit was reduced further.

The staff had perhaps given more emphasis to Trinidad and Tobago's growing external debt than was justified, Mr. Hodgson remarked. A total public debt of 20 percent of GDP and a debt service ratio rising to 14 percent in 1986 were not onerous burdens, especially if they declined over the remainder of the decade as suggested by the medium-term balance of payments outlook. External debt would not be a major problem in the medium term provided that the fiscal deficit was trimmed and steps were taken to encourage greater domestic savings. Nevertheless, exchange rate adjustment in Trinidad and Tobago was overdue. Nonpetroleum exports had stagnated since 1981, and their competitiveness would not be restored without a devaluation or a significant cut in real wages. The authorities had emphasized quite correctly that wage and price restraint was needed to support any devaluation, but that fact should not be used as justification for inaction. While the authorities postponed taking action on the exchange rate, the costs of an exchange rate realignment in terms of restructuring and potential inflation were increasing. He urged them to reconsider their current policy and to implement the needed exchange rate adjustment over time rather than waiting until a major realignment was unavoidable.

The authorities had taken some important strides in the right direction, particularly on fiscal policy, Mr. Hodgson considered. Their firm stand on public sector wages was appropriate and should signal to other sectors of the economy that the petroleum windfall had ended for the time being. Action in other areas would help in the recovery of the nonpetroleum sector of the economy.

Mrs. Walker noted that at the time of the 1983 Article IV consultation, Trinidad and Tobago had faced the need for a comprehensive adjustment program to address imbalances in the economy. The authorities had adopted some adjustment measures, particularly in the fiscal area, that had improved economic performance by the end of 1984, but further action was clearly needed. The Government's policy based on new economic realities needed to be continued to secure a more stable foundation for future growth and a sustainable balance of payments.

Real GDP had declined substantially in 1983 by 7.5 percent, Mrs. Walker observed. Some of that decline had been reversed in 1984, owing largely to the increase in output from the petroleum sector. As petroleum exports were projected, at best, to remain at the current level, output in the nonpetroleum sector must be improved to enable a resumption of real economic growth. To that end, the authorities had announced efforts to stimulate investment and encourage nontraditional exports. She welcomed the improvements initiated by the authorities in the sugar industry, which would however apparently continue to be subsidized by the Government in the medium term. With production costs per ton reaching 20 times the world free market price for sugar, there was a clear need for more efforts to improve the efficiency of the sugar industry. Real value added in the manufacturing sector had continued to decline in 1984, reflecting in part a loss of international competitiveness. A more active exchange rate policy could help to rejuvenate that sector and increase its contribution to growth and total exports.

Future growth prospects depended heavily on continued improvements in the fiscal sector, Mrs. Walker commented. The authorities' plan to reduce further the overall fiscal deficit of the central administration from 7.5 percent of GDP to 5.1 percent of GDP was commendable. She wondered, however, if that goal was realistic given that a public sector wage settlement had not yet been reached. Nevertheless, the authorities should look carefully at the means they had chosen to reduce the deficit. Considering the adverse effects that a further reduction in capital expenditures could have on growth, it might be advisable to look more closely at areas where current expenditures could be curtailed. Furthermore, the authorities should review the present tax system, which appeared excessively complex, with the aim of using more tax incentives--which had been successfully used to encourage growth in the petroleum sector--to promote other areas of the economy. She would be interested in hearing the staff's recommendations regarding taxation.

Central government transfers to nonfinancial public sector enterprises had been reduced in some key areas, and several of those enterprises had made long overdue price adjustments, Mrs. Walker noted. She urged the authorities to continue reducing subsidies to that sector and encouraged them to promote efficiency in those industries, perhaps by moving gradually toward less government involvement. Efforts to increase efficiency were particularly essential if a reduction in government subsidies was not to be offset by the increase in lending by the banking sector to nonfinancial public enterprises.

Financial savings had grown slowly in 1984, reflecting in part the detrimental effects of negative real interest rates, Mrs. Walker observed. She urged the authorities to review their interest rate policy promptly.

Demand restraint had helped to reduce imports and had improved the overall balance of payments position somewhat, Mrs. Walker noted. However, the methods of curbing demand through foreign exchange budgeting and other exchange restrictions, including a multiple currency practice introduced in January 1985, were not the most efficient way of redressing external imbalances while encouraging growth. Furthermore, the significant loss in reserves since 1980, the high rates of inflation experienced by Trinidad and Tobago compared with its major trading partners, and loss of competitiveness of the non-oil sector pointed to a clear need for exchange rate adjustment. The authorities' desire to secure an appropriate incomes policy before effecting an exchange rate adjustment was understandable; their efforts in the area of wages were appropriate, but the exchange rate would have to be dealt with eventually before the system became too restrictive and the balance of payments deterioration more difficult to reverse. She would welcome further comments from Mr. Hospedales on the prospects for an effective wage policy. Finally, she supported the proposed decision and urged the authorities to return to a more liberal trade and payments system that was free of restrictions.

Mr. Wijnholds noted that the staff and the authorities agreed that 1985 was a crucial year for the adjustment process, although they apparently placed different emphasis on some policy issues. Trinidad and Tobago, with the highest per capita GNP in Latin America by a considerable margin, had been unable to maintain the positive trends of the 1974-81 period. GDP had declined in 1983 and 1984 and inflation had remained high. The fall in reserves from SDR 2.9 billion at end-1981 to just over SDR 1 billion at end-March 1985, representing a further decrease of SDR 300 million in the first quarter of the current year, was dramatic, particularly as the country had borrowed sizable amounts from external sources in recent years. That deterioration was due to both internal and external factors. Trinidad and Tobago had been confronted with a weak world oil market. The authorities had, however, recently taken measures to encourage oil production and the first results seemed to be positive. On the domestic side, the fiscal position and wage developments had contributed to the deterioration. The authorities had adopted a more restrictive stand in 1984, particularly with respect to fiscal and monetary policies.

While the authorities' intentions for 1985 appeared appropriate, the staff had doubts about whether they would actually carry them out, Mr. Wijnholds observed. On the expenditure side, wages and transfers had risen rapidly in the past and might be difficult to keep in check, and, on the revenue side, the effect of broadening the income tax base might well be overestimated. The authorities had indicated their willingness to take further action if necessary, and he hoped that they would do so decisively as soon as the need became clear.

The comfortable cushion of reserves was rapidly being depleted so that the authorities had little room to react to a setback, Mr. Wijnholds commented. He agreed with the staff that the authorities could not continue to have recourse to external borrowing for the purpose of financing the budget. While its external debt was still modest compared with many other countries in the region, Trinidad and Tobago would be well advised to avoid excessive borrowing to finance domestic consumption and should work to rebuild the level of domestic savings. Gross national savings had fallen dramatically from a high level of more than 40 percent of GDP in 1980 to a mere 18 percent of GDP in 1984. He joined the staff in urging the authorities to review their interest rate policy. Negative real interest rates appeared to have contributed to private capital outflows, which had become sizable in the past few years. He also noted the unfavorable travel account, showing a net deficit of more than US$100 million for 1985, which was contrary to the experience of most Caribbean islands. He wondered whether gross expenditure for foreign travel--amounting to US$300 million in 1984, a large sum for a country whose population was only 1.2 million--might contain some disguised capital outflows. He asked for staff comment on that point.

Exchange rate policy was clearly a contentious issue, Mr. Wijnholds observed. However, as the U.S. dollar had declined substantially, the high value of the Trinidad and Tobago dollar had become a somewhat less pressing problem. He agreed with the authorities that in the circumstances of Trinidad and Tobago, the use of the exchange rate as a policy instrument depended on the pursuit of an effective incomes policy. He hoped that it would be possible to contain wages to such an extent that the competitiveness of the non-oil sector could be restored without exchange rate action.

He shared the staff's concern about the restrictions on trade and payments, Mr. Wijnholds remarked. A shift from quotas to tariffs would be highly desirable, as would a general lowering of protectionism. He regretted that the authorities had found it necessary to impose further exchange restrictions by introducing a tax on the sale of foreign exchange for travel and remittances abroad. Finally, he supported the proposed decision, urging the member to remove those restrictions.

Mr. Castellanos observed that, after several years of economic and financial deterioration, the authorities of Trinidad and Tobago had undertaken some adjustment measures in 1984 that had halved the overall public sector deficit, slowed monetary expansion, and improved the balance of payments position. The authorities should be commended for those positive results. However, the sustainability of the adjustment process would depend on the adoption of more comprehensive measures in the fiscal, monetary, and external fields.

It would be necessary not only to continue reducing government expenditures but also to improve revenues, Mr. Castellanos considered. The authorities must carefully plan the pace for implementing measures aimed at increasing government revenues, bearing in mind the weakness of economic activity. In any event, revenues must be increased as soon as possible in order to avoid a further deterioration in the fiscal position that would require the adoption of stronger measures. The room for maneuver for reducing public expenditures would be limited if the authorities did not reduce subsidies and transfers and if the Government could not bring wages under control. The financial position of the nonfinancial public enterprises should be clarified, measures should be introduced to improve their operational efficiency, and a prudent position should be maintained regarding the wage negotiations currently under way.

The increasing financial support provided by the Central Bank to some financial institutions was a matter of concern, Mr. Castellanos commented. While he welcomed the authorities' intention to limit the special liquidity support facility, the portfolio problems of those institutions should be examined and their underlying problems solved in a broader framework, namely, the authorities should support only those that were likely to perform well because of their competitive position in the domestic financial market. Positive real interest rates on deposits should be maintained in order to promote domestic savings and discourage capital flight, although he recognized that other factors relating to confidence and risk played a role in those developments.

The external current account deficit had decreased from US$1.1 billion in 1983 to US$0.67 billion in 1984, representing substantial progress toward an equilibrium balance of payments position, Mr. Castellanos remarked. The country's reserve position remained at a relatively comfortable level, and the amount and ratio of external debt service payments were relatively low. Nevertheless, Trinidad and Tobago's external position remained fragile and vulnerable owing to the sluggish developments in the international oil market. The policies aimed at diversifying the economy and exports and at gradually eliminating commercial restrictions were appropriate for building a stable external position in the medium term.

He understood the authorities' view that, in current circumstances, a nominal devaluation of the exchange rate could lead to greater inflation, Mr. Castellanos commented. He had some doubts about the argument presented by the staff that the real effective appreciation of the currency would eventually result in the loss of export competitiveness. However, about 90 percent of exports were petroleum and agricultural products, the prices of which were determined in U.S. dollars in the international market. Thus, an adjustment in the exchange rate could not make those products more competitive; perhaps the staff should have emphasized the need for profitability of export activities rather than competitiveness. In that regard, he would also be interested in learning from the staff or Mr. Hospedales about the procedures for collecting the new tax on sales of foreign exchange for travel and remittances abroad.

In dealing with the financial imbalances of the country, the authorities should take into account the optimal pace of adjustment and should be guided by the need to move toward financial equilibrium without adversely affecting overall confidence in the economy, Mr. Castellanos pointed out. Trinidad and Tobago's potential for economic growth was considerable, given its natural and human resources, but the realization of that potential would depend on the restoration of a more stable internal and external financial position. He endorsed the measures taken during the past year and encouraged the authorities to continue to broaden their scope.

Mr. Clark noted that the recent performance of Trinidad and Tobago's economy had been mixed. On the one hand, he welcomed the reduction of the fiscal and current account deficits from the high levels of 1983. On the other hand, he was concerned that the methods used to achieve those results, particularly on the external side, attacked the symptoms rather than the underlying causes of the problem. The import and exchange restrictions were inefficient and did not address the underlying problems of excessive wage increases and the overvalued exchange rate. The virtual stagnation of non-oil exports in dollar terms over the past four years was of particular concern. Without a change in exchange rate policy, the staff's assumption of a 12 percent annual growth in non-oil exports for the remainder of the decade and of the achievement of balance of payments equilibrium by 1987 seemed somewhat optimistic. The underlying problems would have to be tackled if there was not to be increasing resort to restrictions with detrimental effects on growth in the medium term. He encouraged the authorities to tackle the problems promptly while the external position remained manageable.

It had been possible until recently to finance fiscal deficits by drawing down the large government balances accumulated by the Central Bank during the oil boom years, Mr. Clark remarked. The Government's scope for domestic borrowing was extremely limited; the Central Bank was required by law to lend no more than 15 percent of estimated government revenues. If the deficit persisted, therefore, increasing resort to external borrowing would be required, another reason for prompt action to reduce the deficit further. He was worried by the staff's assessment that, allowing for civil service wage increases along the lines suggested by the Government, the deficit could remain at 7.5 percent of GDP in 1985.

Many of the parastatals remained in a perilous financial situation, Mr. Clark observed. A fairly substantial increase in subsidies to those enterprises was planned for 1985. Like Mrs. Walker, he was concerned that production costs in parts of the sugar industry were about 20 times the present world free market price. As a first step, he wondered if the statistics of those elements of the public sector might be improved and whether Fund technical assistance in that area would be helpful.

He strongly encouraged the authorities to draw up a timetable for the rapid replacement of import restrictions by tariffs, which would increase revenues, Mr. Clark commented. It would be helpful if the staff could give some quantitative indication of the effect of different assumptions about the price of oil on the medium-term balance of payments projections. Trinidad and Tobago faced a serious challenge in adjusting to recent developments in the world economy, especially in the world oil market. The country had the advantage of starting from a relatively strong financial position and from a level of per capita income that had almost reached the top 20 in the world a year or two previously, according to the World Bank Atlas. He hoped that the authorities would make good use of that cushion built up during more favorable times and act decisively and promptly to improve the country's economic position.

Mr. Jayawardena indicated his general agreement with the staff analysis, although his emphasis on certain issues might be somewhat different from that of the staff. Trinidad and Tobago was one of the high-income countries in the developing world. A large part of its wealth emanated from the oil sector, which accounted for 90 percent of exports and 25 percent of GDP. Given the volatile nature of oil in world trade, however, Trinidad and Tobago should be mindful of the need to maintain the international competitiveness of its non-oil sector. He welcomed the commendable progress made since the economic deterioration of 1982-83. It would be important that the authorities achieve their objective of reducing the central government deficit from about 7.5 percent of GDP in 1984 to 5 percent of GDP in 1985.

Efforts were being made to increase taxes and reduce capital expenditures in order to reduce the fiscal deficit, Mr. Jayawardena observed. He would advise the authorities to be cautious in pruning capital expenditures too sharply and to depend less on indirect taxes, which often had a regressive effect. He agreed with the staff that subsidies to the public enterprises and utilities should be reduced and that an appropriate mix of policies, including pricing policies, should be undertaken in that sector.

Small open economies typically experienced problems in adopting fully flexible exchange rate policies, as the benefits of such policies were not clearly evident and the fears of a wage-price spiral outweighed the gains of the depreciation, Mr. Jayawardena continued. Other options that would avoid the need for more serious adjustment were not clear. The long anticipated moderation of the U.S. dollar represented an opportune occasion for the authorities to review their exchange rate policy, with the aim of eliminating the payments restrictions. If those restrictions were not removed, adjustment would fall strongly on fiscal, monetary, and incomes policies. The authorities were taking some courageous measures, and he was confident that they would face their current problems with equal courage and pragmatism.

Mr. Zhang said that he did not agree with the staff regarding the need for Trinidad and Tobago to devalue its currency at present. The overall effects of a devaluation had not been indicated in the staff paper.

The staff representative from the Western Hemisphere Department, commenting on the sensitivity of the balance of payments outcome to changes in petroleum prices, stated that petroleum exports amounted to about 32 million barrels a year at present, so that a decline of US$1 in the price of petroleum would result in a minimum decline of US$32 million in exports. In addition, a decline in petroleum prices would have an impact on exports of petroleum products, including derivatives and by-products, which had become an important part of Trinidad and Tobago's export sector.

The authorities' fiscal policy had previously emphasized cuts in capital expenditures, the staff representative pointed out. The staff had been concerned about the declining trend of capital expenditure, although the reduction in capital outlays reflected, in part, the completion of a number of projects that had been initiated in the boom period of 1981-83.

The staff had made a number of recommendations regarding the tax system in Trinidad and Tobago, including the introduction of a general sales tax rather than the present system of specific taxes on goods and services, which had become extremely inefficient and cumbersome to administer, the staff representative indicated. In addition, a reduction in exemptions on both income taxes and specific taxes on goods and services would be desirable. The Government had moved decisively in that direction, as reflected in its 1985 budget, by increasing the base for taxation of goods and services. Tax measures introduced in 1985 reflected the recommendations made by the staff on earlier occasions.

On interest rate policy, there was virtually no intervention by the Central Bank in the credit markets, the staff representative remarked. While rediscount facilities existed, they were used almost exclusively to finance the state-owned sugar company. Interest rates were set by the eight major commercial banks. It was possible that interest rates had remained low because of problems associated with the competitiveness of the banking system in Trinidad and Tobago. It had been argued by the authorities that savings had remained in the financial system and in the domestic economy because of the widespread capital controls. The staff, however, was not convinced by that argument, as capital had clearly moved outside the financial system or had left the country, as shown in the high negative errors and omissions item in the balance of payments for 1983 and 1984. The demand for credit by the private sector had remained depressed in the recent past, reflecting the low levels of economic activity, particularly in 1983-84, which in turn may have exerted downward pressures on interest rates.

The recent large increase in travel expenditure was due to the significant appreciation of the Trinidad and Tobago dollar, which had resulted in a change in relative prices, thereby increasing demand for goods and services from abroad, the staff representative explained. Imports had not risen in the recent past owing to the restrictive system of import controls and the significant cuts in public sector expenditure. Nevertheless, there must have been an element of capital flight, in terms of imports, payments for services, and travel expenditure. There were, however, limits on the financial resources that individuals could take abroad when traveling.

The staff considered that an exchange rate adjustment in Trinidad and Tobago could be justified only if accompanied by adequate demand and incomes policies, the staff representative commented. Demand management policies had led to a significant improvement in the position of the public sector, which had had a direct impact on the performance of the economy. In general terms, an exchange rate adjustment without action in other policy areas would have only a short-term impact on economic conditions and would affect prices if wage policies remained expansionary. A restrained wage policy was extremely important for the success of an active exchange rate policy.

The balance of payments projections for Trinidad and Tobago indicated that exports of petroleum and petroleum products would grow at a relatively slow pace, the staff representative observed. Export growth therefore depended on the development of other sectors. The staff considered that there was a need for a change in relative prices to strengthen the competitiveness of the external sector. The prices for the country's primary exports were determined largely on international markets, and exchange rate action would therefore have little effect on the prices of Trinidad and Tobago's exports. However, it would have a positive effect on the relationship between export prices and domestic costs and on the prices of certain imported goods. Thus, the competitiveness of the domestic economy would be enhanced in both the export and import-substituting sectors. Given the deterioration in the terms of trade and the decline in petroleum production, the staff was in favor of a devaluation of the currency.

The new 10 percent tax on foreign exchange for travel and remittances abroad was applied at the time of purchase of the foreign exchange and was effected through the banking system, the staff representative from the Western Hemisphere Department concluded.

Mr. Hospedales remarked that, while the appreciation of the real effective exchange rate of the Trinidad and Tobago dollar could have a damaging effect on the country's international competitiveness, Directors must be aware that purchasing power parity comparisons had to be qualified by other indicators of competitiveness. The special problems associated with the identification of an appropriate exchange rate for an oil exporting country were well known; exports of petroleum and related products accounted for about 93 percent of Trinidad and Tobago's total exports. The authorities had therefore adopted a policy of nontraditional export promotion and expansion. Consequently, exports of the new energy-based sector had increased from US$62.5 million, or 2.5 percent of total exports in 1980, to US$174.1 million, about 8.5 percent of exports in 1984, and were expected to increase further in 1985 and beyond. The management of the exchange rate was subject to Trinidad and Tobago's obligations under Article 213(2) of the Treaty establishing the Caribbean Community, which called for extensive consultations. Finally, there would be no point in depreciating the exchange rate outside the framework of a restrained incomes policy, which would require careful political preparation.

The exchange restriction associated with the foreign exchange budget involved only a small number of nonessential consumer goods, Mr. Hospedales went on. That policy initiative had been critical, given that foreign exchange was a scarce resource and given the need to shift resources into the export and import-substituting sectors. The 10 percent tax on the sale of foreign exchange for travel and emigration had been introduced to contain demand and, on another level, to compensate for revenue losses owing to the decline in imports and the erosion of the revenue base. As his authorities considered those exchange restrictions to be of a temporary nature, he suggested that the last sentence of the proposed decision be amended to read "progressive removal of these practices" rather than "prompt removal of these practices."

Fiscal discipline had been strengthened, Mr. Hospedales commented. On the revenue side, indirect taxes had been increased subtantially, a stamp duty of 12.5 percent had been imposed on some imports, excluding food and drugs and capital goods, which were subject to a 6 percent stamp duty. Considerable efforts had also been made to strengthen tax collection. On the expenditure side, efforts were being made to effect stricter control. Current expenditure had been reduced in nominal terms in 1984 for the first time in more than 15 years, and expenditures were being scrutinized for savings in 1985, when it was hoped that the fiscal deficit could be reduced to 5.5 percent of GDP.

His authorities were satisfied with the present pace of adjustment, Mr. Hospedales stated. They were committed to monitoring the whole range of policy measures with a view to improving or strengthening them if the situation so warranted, bearing in mind that the pace of adjustment should be considered in the context of an equitable sharing of the burden throughout the national community.

Considerable progress had been made in tackling the structural problems of the oil sector through official action, Mr. Hospedales noted. The decline in petroleum output, which began in 1978, had been arrested with a moderate increase in 1984, and output was likely to increase further over the medium term, serving to strengthen both government finances and the balance of payments. Refining activities had remained slow, but the Government's recent purchase of the assets of one major oil company was expected to lead to a rationalization of the petroleum sector, particularly refining operations, and to some restoration of viability in this key area of operations. The reserve loss of US$300 million in the first quarter of 1985 was considerably below the reserve loss for the corresponding period in 1984. Progress had been made in that key area.

Finally, his authorities expected financing arrangements to be available in adequate amounts through continuing access to official and private capital markets, Mr. Hospedales indicated. Accordingly, they clearly regretted the recent decision by the World Bank to graduate Trinidad and Tobago from its lending program without due consultation. Positive net transfers from multilateral institutions were critical if developing countries were to achieve their development objectives, and Trinidad and Tobago--a country still on the development path--had a legitimate claim to maintain its access to the Bank's resources.

The Chairman made the following summing up:

Executive Directors were in broad agreement with the thrust of the staff appraisal in the report for the 1985 Article IV consultation with Trinidad and Tobago.

Directors observed that Trinidad and Tobago's economic performance had in recent years been adversely affected by domestic factors and the weakening in the international oil markets. Expansionary fiscal policies and substantial wage increases had resulted in balance of payments and price pressures in 1982 and 1983. The corrective measures initially taken by the authorities in 1983 and intensified in 1984 had led to some improvement in economic performance. Petroleum output had recovered moderately in 1984 in response to fiscal incentives, but production in other sectors remained weak, and the rate of unemployment had increased.

Directors observed that the sizable adjustment of the public sector finances in 1984 had contributed significantly to the reduction of the country's financial imbalances. In particular, they noted the efforts directed at curtailing expenditure and welcomed the progress made in reducing subsidies and increasing nonpetroleum revenue. However, they noted that the reduction in expenditure reflected a drastic curtailment of capital outlays.

Directors underscored the need for prompt additional measures to lower the public sector deficit in 1985. Since further substantial cuts in capital expenditure could adversely affect long-term growth, Directors urged the authorities to review policies with a view to curtailing current expenditures. Directors noted with concern that budgetary transfers and subsidies to public enterprises had been high in the past and were projected to increase in 1985. They stressed the crucial importance for the budget of containing the transfers to the rest of the public sector through more realistic pricing policies and through efforts to raise the operational efficiency of the public enterprises. Directors commended the authorities for their current firm stand against excessive wage demands in the public sector, and they hoped that this would provide a useful signal to other sectors of the economy. Directors also urged the authorities to review the structure of taxation, with adequate technical assistance, if they wished, from the Fund. However, several proposals made earlier by the staff had already been adopted in the 1985 budget.

Directors commented on the relatively poor performance of financial savings in recent years and the generally negative real interest rates prevailing in Trinidad and Tobago. They encouraged the authorities to review interest rate policies with a view to stimulating the growth of savings, improving the allocation of credit, and strengthening the capital side of the balance of payments.

Directors emphasized that policies of demand restraint should be coupled with supply-oriented measures, including the restoration of a viable structure of costs and prices to support a revival of growth and employment. In this regard, Directors noted the authorities' plans for strengthening performance in the sugar industry--for which production costs were some 20 times higher than the world market price--oil refining, and steel industries. A number of Directors noted the substantial real effective exchange rate appreciation that had taken place so far, and Directors' views were somewhat split on the urgency of a move by the authorities toward action in the exchange rate field in order to correct the situation. But, in view of the price effects of a depreciation of the currency, they all stressed that such action, if it were to be taken, would need to be supported by an appropriate policy of wage restraint. While a comfortable level of reserves still remained, the loss of foreign exchange that had taken place in the past was clearly a sign that there was no other option than to continue with determination the adjustment process on which the authorities had already embarked.

Directors observed that present commercial policies included extensive controls. They urged the authorities to eliminate these restrictive practices and liberalize the trade system by shifting from quotas to tariffs in the context of a comprehensive adjustment program.

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

Mr. Hospedales suggested that the word "prompt" in the last sentence of the decision be replaced by the word "progressive."

The staff representative from the Exchange and Trade Relations Department stated that the wording in the proposed decision was identical to that in the decision concluding the 1983 Article XIV consultation with Trinidad and Tobago. A change in the wording would imply that there had been a change in the Executive Board's view on the matter.

The Executive Board took the following decision:

1. The Fund takes this decision relating to exchange measures of Trinidad and Tobago subject to Article VIII, Section 2, and in concluding the 1985 Article XIV consultation with Trinidad and Tobago, in the light of the 1985 Article IV consultation with Trinidad and Tobago conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Trinidad and Tobago has maintained a foreign exchange allocation system for imports since 1983 and a multiple currency practice resulting from a tax on foreign exchange sales for travel and certain remittances since early 1985. The Fund urges Trinidad and Tobago to implement policies which will facilitate the prompt removal of these practices.

Decision No. 7966-(85/68), adopted
May 1, 1985

APPROVED: February 14, 1986

JOSEPH W. LANG, JR.
Acting Secretary