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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/107

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

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	J. K. Orleans-Lindsay, Temporary
	M. K. Bush
	L. Hubloue, Temporary
	S. de Forges, Temporary
	A. Mustafa, Temporary
	M. Sugita
G. Grosche	
J. E. Ismael	
	L. Leonard
	H. A. Arias
	J. Hospedales, Temporary
	K. A. Hansen, Temporary
	A. Abdallah
	M. A. Weitz, Temporary
	J. E. Suraisry
P. Pérez	
J. J. Polak	
	H.-S. Lee, Temporary
	O. Kabbaj
	A. S. Jayawardena
	T. A. Clark
	N. Coumbis
	Wang E.

L. Van Houtven, Secretary
B. J. Owen, Assistant

Also Present

IBRD: G. Koenig, R. Robinson, Latin America and the Caribbean Regional Office. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; M. Guitián, Deputy Director; J. E. Bonvicini. External Relations Department: H. P. Puentes. IMF Institute: U Tun Wai, Deputy Director. Legal Department: J. M. Ogoola, J. K. Oh. Western Hemisphere Department: M. E. Bonangelino, E. V. Clifton, M. A. Da Costa, O. Gronlie, C. M. Loser, L. L. Perez, D. C. Ross, J. E. Sundgren, E. C. Suss, G. Yadav. Bureau of Statistics: R. Pearson. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: G. Nguyen, G. W. K. Pickering. Assistants to Executive Directors: W.-R. Bengs, J. de la Herrán, J. J. Dreizzen, R. Fox, S. Geadah, G. D. Hodgson, O. Isleifsson, H. Kobayashi, M. Lundsager, W. K. Parmena, M. Sarenac, A. A. Scholten.

1. PANAMA - 1985 ARTICLE IV CONSULTATION AND STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1985 Article IV consultation with Panama together with a request for a stand-by arrangement for a period of about 21 months in an amount equivalent to SDR 90 million (EBS/85/152, 6/17/85; and Cor. 1, 7/3/85). They also had before them a report on recent economic developments in Panama (SM/85/179, 6/27/85).

The staff representative from the Western Hemisphere Department noted that the Chairman of the Advisory Committee representing creditor banks had provided information on the status of the external financing program with the commercial banks for 1984, 1985, and 1986. With respect to the new credit facility, by July 12, 1985, 121 out of a total of 188 commercial banks had confirmed their participation for an amount of $59.1 million or 98.4 percent of the $60 million envisaged under the facility. Based on conversations with many of the banks that had not yet responded, the Committee believed that the remaining funds would be fully committed. As for the debt refinancing facility, positive responses had been received from 134 banks--or 72 percent of the total of 185 banks--for $436 million; no negative responses had been received. Commitments had also been made to the working credit facility for various public sector debtors for $54 million, or 96.3 percent of the total of $56 million.

With respect to the debt of the National Bank of Panama, the staff representative added, $28 million had been committed for the petroleum import facility, and $107 million--by 21 banks, representing 80 percent of the amount requested--for the money market facility.

The Advisory Committee believed that the commercial bank facilities would be completed in accordance with the respective terms and conditions, the staff representative stated. The Paris Club had agreed to consider Panama's request for a rescheduling of 1985 and 1986 maturities in September.

The bond issue in Japan for a total of $20 million had been fully subscribed and the amounts had been disbursed in late June, the staff representative noted. It was the first placement of such a bond for a Latin American country since mid-1982.

The authorities had approved the modification to the tariff system mentioned on page 16 of the staff report, the staff representative stated. Import duties would be collected on the basis of c.i.f. rather than f.o.b. values.

Finally, the staff representative from the Western Hemisphere Department noted that preliminary indications suggested that the performance of the public sector in the first five months of 1985 had been satisfactory. The trend should hold for the first half of the year, thanks to high revenues in June.

Mr. Arias made the following statement:

On behalf of my Panamanian authorities, I would like to thank the staff for its excellent report on Panama's Article IV consultation and request for a stand-by arrangement. My authorities are in broad agreement with the general thrust of the staff's analysis.

The unsustainability of the public sector deficit in 1982 had led the Government of Panama to implement an economic program supported by an 18-month stand-by arrangement from the Fund.

Under that program, which covered the period from June 24, 1983 to December 31, 1984, the Government of Panama attempted to strengthen the finances of the public sector, particularly through tight fiscal measures. Previous staff reports have pointed out in detail the various revenue and expenditure measures adopted during the course of that stand-by arrangement, as well as the significant improvements achieved in the finances of the public sector. Thus, I shall not dwell at length on such performance, but I would like to mention that the overall public sector deficit declined from $464 million--11 percent of GDP--in 1982 to $247 million--5.8 percent of GDP--in 1983, compared with a program projection of $270 million--6 percent of GDP.

In 1983, economic activity in Panama was stagnant for the first time in seven years, reflecting the worldwide recession. Economic activity declined in 1984, in contrast to the projection of 2 percent growth in the program. This led to a significant shortfall in central government revenues. The overall public sector deficit was $266 million--6.2 percent of GDP--which was within the cumulative limits for the period of the stand-by arrangement. Panama complied with all performance criteria under the stand-by arrangement in 1984, and my authorities purchased the total amount agreed under the arrangement with the Fund of SDR 150.0 million.

On October 11, 1984, a newly elected Government took office. The Government's economic policy is aimed at reorienting the incentive structure toward export promotion and employment generation, improving the efficiency of the public sector, and fostering the growth of the private sector. To this end, my authorities have designed a financial program intended to continue strengthening the finances of the public sector and slowing down the rate of growth of the external debt, while making efforts to reorient economic policies so as to improve resource allocation. To achieve these objectives, the support of the Fund is a key element. For this reason my Government has requested a stand-by arrangement for 21 months in an amount equivalent to SDR 90 million (88 percent of Panama's quota of SDR 102.2 million, or 50 percent of quota on an annual basis).

The economic program for 1985-86 is well balanced and deserves the Board's support. The program is intended to build on, and strengthen, the adjustment effort initiated in 1983, particularly in the fiscal area. The financial program will result in an improvement in public sector savings from 1.6 percent of GDP in 1984 to 3.1 percent in 1985 and about 3.8 percent in 1986, which, together with a contraction in capital investment from 8.2 percent of GDP in 1984 to 6.9 percent in 1985 and to 6.2 percent in 1986, will lead to a further decline in the overall public sector deficit to $160 million, or 3.5 percent of GDP in 1985 and to 2.6 percent of GDP in 1986.

On the revenue side, the measures that have been adopted since the first quarter of this year are expected to yield about 1.7 percent of GDP. Among the most significant is the partial elimination of the public sector's exemption from payment of import duties; this measure should yield approximately $12 million; the remaining exemptions essentially cover imports of medicines by the Social Security Agency and of goods by the Agricultural Marketing Board (IMA). In support of the Government's willingness to strengthen customs administration and to boost revenues, the Cabinet approved, in mid-June, the introduction of the Brussels Nomenclature, and also the conversion in the valuation of imports for the purpose of tariffs from an f.o.b. to a c.i.f. value basis. This measure will have both a direct and indirect impact on central government revenues of approximately $9 million in 1985, through an increase in import duty receipts on the one hand, and an increase in the base on which the value-added tax is levied. Moreover, increases and new fees for insurance companies, banks, and corporations have been implemented, as pointed out in the staff report. There are other revenue measures which have been described in detail in the staff report.

On the expenditure side, tight control will continue to be exercised over public sector expenditures. Under the program, the overall expenditures of the nonfinancial public sector will be slightly reduced. The current expenditures of the Central Government are expected to increase by 3.7 percent, which reflects increases in public sector interest payments, that account for 26 percent of public sector expenditures. Moreover, non-interest-bearing current expenditures will decrease by 3.1 percent. No general wage adjustments, apart from those already committed, are envisaged in the public sector for 1985; therefore a large portion of wages will remain at the level of December 31, 1984. Moreover, the government budget for 1985 includes the elimination of positions by attrition. In 1985 public sector capital expenditures are projected at $313 million, which represents a reduction of more than 14 percent from the 1984 level. The level is consistent with the availability of financing that has been assessed as being appropriate by the World Bank.

My Government is committed to the continued improvement of public sector efficiency. To this end, since 1983, my authorities have been embarked on a program that includes a more efficient management of state-owned enterprises, the establishment of coherent investment programs consistent with the priorities for development, as well as a gradual rationalization of public sector enterprises. While there still are some unprofitable enterprises, my authorities have already taken a number of decisions aimed at reducing financial transfers from the Central Government to certain public enterprises and decentralized agencies. Among these actions, the National Finance Company (COFINA) has ceased its lending operations and the National Bank will serve as trustee for the administration of the revenue collection. In addition, the Government is seeking to sell to the private sector various public enterprises that are currently incurring losses. Once again, my authorities feel that to enhance public savings, fundamental structural reform should be addressed without much delay.

The Comptroller General's office has been granted the power to institute rigorous administrative controls to supervise all central government institutions and decentralized agencies. Of particular importance is the requirement that all public enterprises must report to the Comptroller's office their revenues and expenditures for each quarter within 15 days after the end of that quarter. In the case of revenues that are lower than programmed in the budget, that agency must then adjust its spending level to the revenues accruing. Moreover, should the revenues turn out to be higher than expected, that increase cannot be offset by an increase in expenditures but, rather, must be deposited at the National Bank so as to improve its liquidity position. In addition, if at any time during the fiscal year, the Ministry of Planning and Economic Policy estimates that total revenues will be lower than total budgeted central government expenditures, the Minister will present to the Cabinet a plan for a reduction in spending so as to avoid an increase in the deficit. In addition, any obligation, disbursement, agreement, or any other spending commitment by the public institutions without prior approval, as required by law, will not be recognized by the Ministry of Planning and Economic Policy, nor by the Comptroller General's office.

Progress has been made in the area of trade restrictions and price controls. Conversion of almost all import quotas into tariffs has been completed and price controls have been eliminated for most of these items. My authorities consider this plan consistent with the Government's objective over the medium term to foster private sector investment in new export-oriented activities.

One of the main objectives of this program, as in the case of the previous one, is to slow the rate of growth of external debt and improve its maturity structure. To this end the rate of growth of public external indebtedness is programmed to be reduced from 5.3 percent in 1984 to 4.3 percent in 1985. The size of the public sector deficit for the period of the program has been determined on the basis of the available financing from multilateral and bilateral agencies together with a $20 million floating rate bond issue--the first successful voluntary placement by a Latin American country since 1982--which has been placed and disbursed, and $60 million of fresh money by commercial banks, which will partially cover bond amortizations due in 1985-86. The requirement that the public sector will have no net recourse to commercial financing apart from that already mentioned, together with the establishment of ceilings on credit of the National Bank to the public sector, will ensure that the total public sector deficit will be maintained within the targets envisaged in the program.

Panama has successfully negotiated with the international banking community a $600 million debt restructuring package to cover amortization payments from commercial banks falling due in 1985-86. Also, my authorities have submitted to the Chairman of the Paris Club a proposal for the refinancing of official credits of approximately $8 million in 1985 and $16 million in 1986.

My authorities feel that this program is realistic and consistent with the Government's strategy to rationalize the role of the public sector and to increase that of the private sector in the economy, while strengthening the fiscal position. Finally, my authorities, as in the past, will be in continuous consultation with the Fund on the implementation of the program.

Mr. Pérez said that he was in broad agreement with the staff appraisal and that he supported the proposed decision. The Panamanian economy had begun to register increasing imbalances in the early 1980s owing in part to the unfavorable external environment but mainly to large fiscal deficits, especially in 1982. The authorities had taken prompt action to reduce those imbalances and, within the framework of a stand-by arrangement, had adopted a set of measures aimed principally at reducing the deficit of the Central Government and stabilizing the external sector. The first phase of a medium-term adjustment program had been successfully concluded in 1984. Despite a less favorable internal and external environment than envisaged for the first part of the program, the stabilization effort in general and the fiscal adjustment in particular had been implemented successfully. The reduction of the overall public sector deficit from 11 percent of GDP in 1982 to 6 percent of GDP in 1984 was particularly commendable.

In spite of the fact that all the quantitative targets of the stand-by arrangement had been met, Mr. Pérez continued, the public sector deficit and the external position remained far from being manageable. In addition, Panama's curtailed access to capital markets, high debt service ratio, and debt profile warranted a new stand-by arrangement accompanied by a debt rescheduling arrangement. The proposed stand-by arrangement seemed to be a well balanced and appropriate vehicle for supporting the authorities' continued efforts to redress the fiscal situation. The fiscal deficit, after having been reduced significantly during the past two years, was expected to decline again in 1985 and 1986. The measures adopted to increase revenues and to supervise the expenditure of all central government institutions and decentralized agencies seemed reasonable. However, he would expect the authorities to continue to improve the operations of state-owned enterprises and other public agencies. A salary freeze, the elimination of posts by attrition, and other cuts in current and capital expenditures should contribute to a decline in the fiscal deficit while making room for a more active role for the private sector.

He had noted with interest that the Panamanian authorities intended to combine their demand policies with aggressive supply-side policies, Mr. Pérez went on. Measures were being taken to improve export competitiveness and to foster private sector investment in new export-oriented activities. To that end, the structure of incentives had been modified, and domestic prices had been liberalized to achieve a more efficient allocation of resources. In his opinion, a strengthening of the measures aimed at increasing exports would be the best way for Panama to obtain the external resources needed to reduce the heavy burden of external debt. Thus, he supported the authorities' intention to carry out a complete diversification program, with the support of the World Bank, and to accelerate trade liberalization.

Mr. Weitz stated that he supported the proposed decision. The Panamanian authorities had followed an adjustment program supported by the Fund since early 1983. Price developments had been much more favorable than expected and the rate of inflation had declined from 5.4 percent in 1982 to 1.5 percent in 1984. The reduction of inflation was especially noteworthy because in an economy like that of Panama, excess domestic demand and domestic price developments affected the current account of the balance of payments, reflecting changes in world prices for imports and exports.

In spite of negative external developments, the authorities had also made a major effort to reduce the fiscal imbalance, Mr. Weitz added. For a country without an independent monetary policy and where the U.S. dollar circulated as the medium of exchange, fiscal adjustment was essential to correct imbalances in the external accounts. It was gratifying to learn from the staff representative that the performance of the public sector in the first five months of 1985 had been satisfactory.

The adjustment program of Panama should improve the prospects for the economy, Mr. Weitz considered. One question that needed to be answered was how the competitiveness of the economy could be improved, given Panama's limited macroeconomic policy instruments. Wage restriction was one possibility but a more general policy approach related to the productivity of the economy as a whole was needed. One positive aspect of current developments in Panama was the program of structural reform that the new Government planned to develop. In particular, the reduction of the Government's role in the economy and support for the private sector were steps in the right direction if the authorities wanted to achieve growth in the medium term. The intention of the authorities to liberalize trade policies with the objective of improving incentives for employment and export production in the industrial sector was welcome. Fortunately, the World Bank was supporting that structural reform effort, which would lead to an improvement in economic efficiency.

The Government should pay particular attention to reducing fiscal imbalances, Mr. Weitz noted. The public sector deficit was expected to decline from 6 percent of GDP in 1984 to 3.5 percent of GDP in 1985 and 2.6 percent of GDP in 1986, an appropriate effort. However, the authorities recognized certain weaknesses in the collection of some taxes, in particular import duties and the value-added tax. With respect to expenditures, the huge interest payments that the authorities would have to make in the near future were a matter of concern. The measures outlined in the program should be implemented fully in order to restrain the expenditures of the Central Government.

The planned improvements of public enterprises were constructive, Mr. Weitz considered. He had in mind in particular the measures recently approved in the budget, requiring all public enterprises to report revenues and expenditures to the Comptroller General, together with a general tightening of regulations.

Panama's increasing external debt and the heavy debt service payments falling due over the next few years were clearly of concern, Mr. Weitz remarked. The authorities planned to ease the debt service burden over the medium term by lowering the share of commercial debt in total public debt. To achieve that desirable objective, it would be vital for Panama to receive support from multilateral institutions.

Mr. Coumbis noted that the Panamanian authorities had taken a number of measures in the public sector in 1983 and 1984 to increase revenues, restrain expenditures, and adjust the prices charged by, and streamline the operations of public enterprises. As a result, there had been a remarkable improvement in the overall public sector deficit in 1983, but a less satisfactory one in 1984. However, the cumulative overall deficit of the nonfinancial public sector for those two years had been within the limits of the program. The adjustment effort during that period had not been easy because the economy had been affected adversely by many external factors.

Among the weaker aspects of performance under the adjustment program, public sector savings during 1984 had been a disappointing feature of the fiscal outcome, Mr. Coumbis continued. Furthermore, public investment had been about 15 percent below the programmed level in order to compensate for the increase in current expenditures and the reduction in public revenues in relation to the targets. Some of the basic economic variables had not developed favorably. GDP had declined by a cumulative 2 percent in 1983 and 1984, and construction activity had fallen by one third in 1983. The deficit on the current account, which had been reduced significantly in 1983 compared with 1982, had increased again in 1984. At the same time, the rate of inflation had decelerated substantially in 1983 and 1984. Of course, Panama's policy options were limited by the lack of a central bank and by the fact that the U.S. dollar circulated freely as legal tender.

He was in general agreement with the staff appraisal and supported the broad objectives of the proposed stand-by arrangement, Mr. Coumbis said. Also, he had no objection to the proposed policy mix or to the quantitative performance criteria. Policies relating to the public sector during 1985 and 1986 would be crucial to the successful implementation of the adjustment program. With respect to government expenditures, he had taken note of the intention to place tighter controls on budgetary allocations for purchases of goods and services, the wage freeze enacted in December 1984, the decision not to fill vacancies created by retirement and resignation, and the reduction of public sector employment by 5,000 positions. He would be interested to know whether those public sector employees would be dismissed without compensation or pensions, or whether they were being retired early. The new monitoring procedures for controlling the finances of public enterprises and agencies were also important, as were the plans of the authorities to restore the soundness of the Social Security Agency over the medium term. The objective of reducing the public sector deficit to 2.6 percent of GDP in 1986 from 6 percent of GDP in 1984 was ambitious, especially considering the rather weak performance of the public sector during 1984. The adjustment effort would place heavy demands on the Panamanian authorities, who would need to show strong determination if it was to be implemented successfully.

Panama had had 15 stand-by arrangements with the Fund, and the medium-term scenario indicated that it would require financial assistance from the Fund for many years, Mr. Coumbis observed. Therefore, although he accepted the staff assessment that the authorities were committed to continuing their efforts to strengthen public finances and improve resource allocation, he considered that the Fund should gradually limit itself to a catalytic role. Panama should obtain the financial assistance it needed from bilateral and other multilateral sources.

Mr. Suraisry noted that Panama's performance under the recently expired stand-by arrangement had been generally satisfactory. The authorities had made progress in reorganizing public finances, reducing inflation, and liberalizing the trade system. Nevertheless, there had been some slippages and the economy continued to face difficult problems, particularly on the external side. The debt service burden was heavy and the availability of foreign financing was limited. Further adjustment was required to strengthen the public finances, improve the allocation of resources, and lessen Panama's reliance on external borrowing.

The proposed program provided the right framework for achieving those important objectives, Mr. Suraisry considered. Fiscal restraint was central to the adjustment effort, and comprehensive measures had been taken to raise revenues and reduce current expenditures. The authorities should implement their plans to improve tax administration and to introduce more realistic pricing policies for the public enterprises. Such measures were essential to increase domestic savings and to finance the investment required for future growth.

Fiscal restraint was also necessary if Panama was to retain the confidence of its external creditors and improve its debt profile over the medium term, Mr. Suraisry remarked. In present circumstances, the authorities' reliance on a two-pronged strategy of firm demand management and debt restructuring seemed appropriate. Over the longer term, Panama had considerable scope for expanding the productive base of its economy and promoting private sector activities. It was encouraging that the authorities were working closely with the World Bank in those areas. He supported the proposed decision.

Mr. Grosche noted with regret that Panama's economic performance in 1984 had been significantly weaker than expected and that most of the progress made toward adjustment in 1983 had been lost. The overall public sector deficit as well as the current account deficit had risen far above their 1983 levels. Fiscal performance had weakened during 1984 as a consequence of revenue shortfalls and current expenditure overruns. Public sector savings and gross national savings had not only fallen considerably short of the program target for 1984 but had been significantly below the 1983 levels. Furthermore, waivers of performance criteria had had to be granted twice in order to enable Panama to make all scheduled purchases under its stand-by arrangement.

Against that background, he had some difficulty in sharing the staff assessment that "Panama's performance under the 1983-84 stand-by arrangement was in general satisfactory," Mr. Grosche observed. He recognized that the authorities had continued their commendable efforts at reform by liberalizing trade policies and reducing the scope of price controls. They had also continued to abstain from applying restrictions on payments and transfers for current and capital transactions. Price developments had been much more favorable than expected. However, the significant departures from the program in 1984 indicated a compelling need for strong corrective action. Therefore, he had been glad to note that the authorities were determined to bring about a sizable adjustment under the 1985-86 program for which they had requested continued Fund support.

Nevertheless, he supported Panama's request for a stand-by arrangement, only with some reservations, Mr. Grosche said. Panama was apparently about to become another prolonged user of Fund resources, having entered into arrangements with the Fund continuously over a number of years in an amount equivalent to 263 percent of its quota. In addition, he had been somewhat concerned to note from the staff report that Panama was likely to continue to require the Fund's financial support after the expiration of the requested stand-by arrangement. His concern was heightened by the fact that Panama would face substantial financing gaps, which were projected to reach a cumulative amount of more than $1.6 billion by 1990. Only if the authorities stuck to their adjustment goal would the commercial banks be ready to refinance the huge amortization payments that were at the heart of those financing gaps.

A number of commendable actions had been taken already under the adjustment program, Mr. Grosche noted, including the wage freeze in the public sector and measures to increase budget revenues. The tighter controls on budgetary allocation to avoid renewed expenditure overruns as well as the new monitoring procedures to strengthen controls over the public enterprises were particularly welcome. Yet a strengthening of the tax collection procedures seemed necessary to ensure the attainment of the revenue projections for 1985.

While fiscal restraint would remain the cornerstone of the adjustment effort, Mr. Grosche added, complementary measures were required to maintain Panama's international competitiveness, which had been affected negatively by the real appreciation of the exchange rate. With the U.S. dollar as legal tender and a medium of exchange, Panama could not pursue its own exchange rate policy. Thus, international competitiveness would have to be maintained by improving productivity and keeping costs under control.

If foreign creditors were to be convinced that Panama deserved continued support in coping with the huge amortization payments that would fall due in coming years, Mr. Grosche stated, those adjustment efforts would have to be continued after the expiration of the stand-by arrangement.

Finally, Mr. Grosche made two points of presentation relating to the summary of the latest developments in Fund relations with Panama. Generally, such summaries were most helpful, but in reporting on the outcome of the 1984 Article IV consultation with Panama, the staff had omitted any mention of the particular concerns expressed by Executive Directors about the widening overall public sector deficit, concerns that had proved justified. Furthermore, contrary to the usual practice, the staff had given no data on Panama's previous arrangements with the Fund, with the exception of the most recent arrangement. If such information had been provided, it would have revealed that the 1982 arrangement had gone off track rather quickly.

Ms. Bush said that she could support the proposed stand-by arrangement in support of a program that would, if implemented, improve the short-term fiscal position and lengthen the maturity structure of Panama's external debt. Her concerns related to the prospects for longer-term growth and development and to what appeared to be a less than fully integrated Fund-Bank collaboration effort.

While the fiscal adjustment in 1984 had fallen somewhat short of expectations under the previous program, the adjustment programmed for 1985 and expected for 1986 was quite substantial, Ms. Bush continued. Strong fiscal adjustment would be particularly helpful since the attainment of the targets would imply that no net financing of the deficit on the part of the National Bank would be required. In addition, the various measures in the fiscal package appeared to be broadly appropriate. Real wages seemed to have increased by a sizable amount in 1984, with increases in nominal wages having exceeded inflation by enough to more than compensate for expected inflation in 1985. Thus, tight controls on public sector wage increases should be maintained in 1986. The commitment of the authorities to pare down the size of the civil service in 1985 was welcome. Such measures were difficult to take, but in the long run they would improve the fiscal position.

Developments in the public enterprise sector, especially the improvement of the Social Security Agency, were on the right track, Ms. Bush considered. However, her authorities would have preferred a faster pace of rationalization, and they were somewhat concerned about the small deterioration expected in the overall position of the public enterprises in 1985. The impact of some measures already taken would not be felt until 1986. She would be interested in having detailed information on how the introduction of a more realistic structure of prices and charges could be accelerated since a speedy overall improvement in the fiscal position was so crucial to Panama's adjustment effort.

Although the program would require no net increase in government borrowing from the National Bank of Panama during the program period, seasonal fluctuations in credit would have to be accommodated, Ms. Bush noted. The liquidity position of the National Bank remained tight and it should be strengthened. Since the public sector was not expected to run a surplus, the National Bank would have to resort to external financing to improve its balance sheet. When the structural adjustment loan from the World Bank was fully disbursed, along with additional disbursements from commercial banks, the authorities should utilize some of those flows to build a cushion of reserves in the National Bank in 1986. Such a precautionary step would provide assurance to external creditors that Panama could weather any temporary adverse developments. For that purpose, however, the authorities would have to begin planning their 1986 budget immediately in order to match those domestic priorities with available external financing, the amount of which was already known.

It was a matter of some disappointment that nothing more explicit by way of structural measures had been included in the Fund program, given Panama's very low rate of growth, Ms. Bush observed. In some sense, such measures were indirectly included, especially as improvements in the overall public sector required structural improvements in the public enterprises. Nonetheless, that aspect of the adjustment effort seemed to have been left almost entirely to the World Bank. Although it was certainly appropriate for the World Bank to play an important role, the Fund could have a reinforcing role if it took up those issues more explicitly.

Her authorities were also concerned about the long time it would take for the structural adjustment loan to be approved, Ms. Bush continued. Apparently, the Panamanian authorities had to show progress on several legislative matters, and she asked how quickly that action could be taken. There was clearly no room for delaying progress on finalizing the terms of the structural adjustment loan, as the information in the staff report on the financing gap for 1985 showed. Unless the Executive Directors of the World Bank approved the loan by some time in December, the commercial banks would be unable to disburse the full amount of new money promised for 1985. If the financing gap in 1985 could not be filled, the performance criteria for end-December would not be met. Therefore, she urged the World Bank to accelerate the processing of the structural adjustment loan and the Fund to be supportive of that effort. Most important, the Panamanian authorities must move quickly on the structural measures, which were vital for other reasons relating to the medium-term outlook.

Apparently, it was assumed that the commercial banks would have no choice but to reschedule amortization payments for several years ahead if the projected financing gaps were to be closed, Ms. Bush remarked. She would prefer to see more emphasis placed on structural adjustment efforts to promote the growth and development needed to generate the resources required to finance repurchases to the Fund later in the decade. Thus, export diversification and growth became a necessity. The correct priorities had been set out in the staff report and by Mr. Arias in his statement. Private sector initiatives were vital to broadening the export base beyond the traditional nonpetroleum exports of bananas, sugar, and shrimp. The elimination of rigidities in the labor market, a major objective of the structural adjustment loan, was also of high priority. In addition, wage restraint was needed to restore the competitiveness of Panama's labor force.

To conclude, Ms. Bush said that her emphasis on the medium-term aspects of the Fund and Bank programs and of Panama's economic plans was related in part to her concern about Panama becoming a prolonged user of Fund resources. Such an outcome could be avoided if ample attention were given to medium-term and structurally oriented measures.

Mr. Polak stated that he agreed with the staff appraisal and that he was willing to support the proposed decision. His concern on the fiscal side was whether it would prove possible to achieve the aim of halving the public sector deficit in 1985 without running the risk of further reductions in official investment expenditure, which would have adverse repercussions on economic growth. The subject was of more general interest because in far too many countries, investment expenditure--usually by the government but sometimes by the private sector as well--ended up bearing the burden of adjustment when other fiscal action proved insufficient. The resulting slow growth could then be connected to Fund programs. Government investment expenditure was already on a downward trend in Panama. As Mr. Arias had stated, public sector capital expenditure in 1985 was projected to be more than 14 percent below that in 1984, when it had been cut by about 15 percent from the programmed level in order to compensate for increased current expenditure. The World Bank had endorsed Panama's investment needs and it should be a matter of concern to the Fund that investment be maintained at the 1984 level. Public sector revenue performance had been unsatisfactory in both 1983 and 1984, and the staff had noted strong political opposition to certain new tax measures. Furthermore, the target for fiscal revenue growth had had to be adjusted downward in the first few months of 1985. In the circumstances, there was considerable ground for concern that a repetition of underperformance in raising revenue or in curtailing current expenditure might lead once more to a reduction of needed government investment expenditure.

As for the length of the proposed arrangement with Panama, Mr. Polak remarked that in the past few days, the Executive Board had been asked to approve arrangements for periods of about two years for several countries, raising the question of prolonged use. He had been unable to discern any convincing reason for arrangements for more than one year. As he had said at the previous meeting, a two-year arrangement would have been more reasonable than a three-year arrangement for Chile. He hoped that a new trend toward longer arrangements was not emerging.

The staff representative from the Western Hemisphere Department said that the failure to mention all of Panama's previous stand-by arrangements in the section of the staff report on relations with the Fund had been an oversight. The summary of the Chairman's summing up of the Executive Board's discussion of the 1984 Article IV consultation had been meant to reflect the gist of Executive Directors' comments, including the concerns about fiscal policy. Even greater care would be taken by the staff in future in preparing such summaries.

Because of Panama's inability to follow an independent monetary policy, the program had to rely mainly on the adjustment of the public sector finances, the staff representative noted. The adjustment in 1983 and 1984 had been considerable; the deficit for the two years had been cast in cumulative terms in the program and it had been below the ceiling envisaged, despite some weakening of the adjustment effort in 1984. The reduction in the deficit in 1985 and 1986 envisaged in the program reflected both the decline in capital expenditure due to the completion of a number of projects and an increase in domestic savings to finance the domestic investment effort. For example, the level of capital expenditure through 1984 had been affected by the completion of a major hydroelectric project, the Fortuna dam. It was also envisaged that the public sector would be reduced in size. The level of public sector investment in the program for 1985 and 1986 had been supported in general by the World Bank staff in its initial assessment of the program. Both the World Bank staff and the Fund staff had urged the Panamanian authorities to review any possible additional cuts in public sector investment with great care so as not to jeopardize the prospects for economic growth over the medium term. However, it was to be noted that overall investment in Panama would increase over the program period because of higher private sector capital formation. Also, the increase in domestic savings to finance investment would reduce the gap between investment and savings over time, thereby leading to a reduction in the current account deficit.

A number of measures that had been introduced in 1985 should be sufficient to strengthen the public sector finances in the following year, the staff representative explained. For instance, the change in valuing imports from an f.o.b. to a c.i.f. basis for tax purposes would begin to be felt in 1986 as would a number of measures affecting the Social Security Agency. The wage freeze imposed in 1985 would have a significant impact in 1986; public sector finances for the current year were still reflecting salary increases granted during 1984-85. The reduction in the number of positions in the public sector would begin in July 1985 and continue through early 1986, thereby having its full impact in that year. It was for those reasons that the two years of the program were so closely connected. However, additional measures might be needed to achieve the targeted deficit of 2.6 percent of GDP for 1986. The Panamanian authorities and the staff would discuss the issue at the time of the review envisaged for late 1985.

The financing gap presented in the medium-term projections for 1987 through 1990 revealed the structure and size of the public sector debt and the significant amounts of amortization falling due in the near future, the staff representative continued. The commercial banks, the main creditors having to consider restructuring Panama's debt, considered that Panama's ability to refinance and to restructure those obligations would depend very much on the policies of the public sector. In that respect, discussions would continue between the Panamanian authorities and the commercial banks. Although monitoring by the banks would probably continue as well, the commercial banks had not indicated the need to establish a formal monitoring procedure extending beyond the period of the arrangement.

As to the link with borrowing from commercial banks, it was true that disbursements by banks in 1985 would depend on the World Bank's approval of the structural adjustment loan for Panama, the staff representative commented. Therefore, it was of the utmost importance for the Panamanian authorities to implement the policies--industrial, agricultural, and those relating to labor legislation--envisaged in the program supported by the structural adjustment loan. Cooperation between the World Bank staff and the Fund staff always had to overcome the hurdle set up by the different time horizons and methods of operation of the two institutions. Once those differences were well understood, cooperation proceeded smoothly, as it had in Panama. The aspects of structural adjustment mentioned in the letter of intent of the Panamanian authorities were very complex. The areas of policy to be modified were apparently the subject of intense discussion in Panama at present; depending on the outcome, policy proposals would be presented to the legislature and progress should be visible thereafter.

The prospects for the medium term were closely linked to the two issues of structural adjustment and investment policies in the public sector, the staff representative from the Western Hemisphere Department concluded. The staff had indicated clearly to the authorities the need to pursue structural adjustment policies and to review carefully the level and composition of public sector investment. Only by taking that course of action could the authorities expect the medium-term projections presented in the staff report to materialize.

The Deputy Director of the Exchange and Trade Relations Department remarked that prolonged use of Fund resources did not simply depend on the number of arrangements that a member had entered into with the Fund. Although Panama had had nine stand-by arrangements since 1973, it had made no purchases under six of those arrangements concluded in the 1970s. The first four arrangements--between 1973 and 1977--had been in the first credit tranche, and thereafter the arrangements had reached into the upper credit tranches. Panama's large outstanding purchases reflected essentially drawings made under the 1983-84 arrangement, which had been for the equivalent of 150 percent of quota. The staff attempted to evaluate what constituted prolonged use on a case-by-case basis, taking into consideration not only the number of arrangements but the extent of use of Fund resources, or their lack of use, when the member's request for Fund resources had been in line with the classical concept of a stand-by arrangement.

The fact that several recent stand-by arrangements had been for periods in excess of one year did not indicate a particular trend toward longer than one-year arrangements, the Deputy Director noted. Many members formulated their policies in terms of calendar years, and when negotiations took place or were concluded at the midpoint of the year, it seemed reasonable for the arrangement to cover the subsequent calendar year in full. The extension of Panama's arrangement into 1987 was designed to ensure that performance criteria for end-December 1986 would in effect condition purchases rather than being simply indicative in character.

The staff representative from the World Bank noted that although Panama's problems were of greater concern to the World Bank from the longer-term point of view, the collaboration between the Fund staff and the World Bank staff had had a mutually reinforcing influence on negotiations with the Panamanian authorities. The World Bank staff supported the terms of the stand-by arrangement because they were very much in line with the program under the first and the proposed second structural adjustment loans. In terms of scheduling, a key element in the processing of the loan was the submission by the Government to the World Bank of a letter of development policy. Once the letter from the Panamanian authorities had been received in mid-May, a fairly detailed but tight schedule had been drawn up according to which the loan would be submitted to the Executive Directors in time for its disbursement before the end of the calendar year. The proposed structural adjustment loan had been brought before the Loan Committee on schedule but the Committee had asked the staff to make the negotiations on the loan subject to legislative approval and to enactment of the Industrial Incentives Law and the modifications of the Labor Code. The World Bank staff mission to appraise the investment program had started work in early June but had had to suspend its assessment because the Panamanian Government had decided rightly to engage in an intensive dialogue on those issues with the industrial sector, including the labor unions. However, it was expected that the agreed schedule would be respected.

Mr. Arias observed that Panama's economy had suffered from serious fiscal imbalances and structural maladjustments to which his authorities had paid a great deal of attention. They believed that they had made a good start in overcoming those problems through strict austerity measures to restore fiscal stability and structural adjustments to correct economic distortions and inefficiencies. His authorities were aware that they should maintain their efforts and safeguard their achievements. Thus, an increase in public sector savings was a key element in the support of investment programs that consequently would boost private sector initiatives and employment, while producing a multiplier effect that would help to reduce Panama's debt service payments in the medium term. As he had pointed out in his opening statement, that was one of the principal objectives of the Panamanian Government.

The recognition by the Government that the public sector was under financial strain underlay the decision to initiate major reforms affecting industry, agriculture, and labor--in order to give incentives to the private sector, Mr. Arias continued. The overall objective was to develop a framework within which the allocation of resources toward export activities would be facilitated and new policies introduced that could gear the economy toward greater productivity and higher employment. The task would not be easy. His authorities believed that to achieve sustainable economic growth in future, the encouragement of private initiative would be of vital importance. To that end, a national dialogue was under way and would have to be brought to a successful conclusion before those reforms could be effectively implemented; no less important, the international conditions would have to be more favorable. In that respect, his authorities had attached a great deal of significance to the previous program supported by the Fund, as well as to the program to be supported by the stand-by arrangement under consideration. Fund support had allowed

Panama to make significant fundamental progress in establishing the conditions necessary to return the economy to a path of sustainable growth.

The Chairman made the following summing up:

Executive Directors welcomed the policies introduced in the new adjustment program covering 1985 and 1986 and supported by a 21-month stand-by arrangement with the Fund. Directors endorsed the continued emphasis of the program on fiscal adjustment and viewed the public sector deficits targeted for 1985 and 1986 as appropriate, in light of Panama's debt service burden and its limited access to foreign financing. They noted that considerable efforts would be required on the part of the authorities if the objectives of the program were to be achieved. Directors gave particular emphasis to the projected reduction in the fiscal deficit from 6 percent of GDP in 1984 to 2.6 percent in 1986.

Directors welcomed the revenue measures introduced in 1985, but they urged the authorities to strengthen tax administration to help achieve the revenue objectives envisaged in the program. Directors also emphasized the need to continue the efforts to improve the overall financial position and the pricing policies of the public sector enterprises and agencies, as an integral part of the proposed adjustment, and they noted that faster progress in this area was imperative if the planned improvement in the fiscal position was to be attained. The authorities would be well advised, it was noted, to make a major effort to create more room for maneuver in the fiscal field and to stand ready to take additional measures if needed to ensure fulfillment of the projections.

Taking into account the heavy public debt service burden, Directors observed that the restraint of current expenditure was to be a major source of fiscal correction and, in this regard, they viewed the wage freeze and the proposed curtailment in public sector employment as particularly important measures. It was noted that the structure and level of public sector capital expenditure was seen by the World Bank staff as generally in line with the priorities of the development strategy and resource availability. In that context, it was observed that further curtailment of spending for capital formation should be undertaken with caution in order to avoid adverse repercussions on the prospects for economic growth over the medium term.

Directors welcomed the intentions of the authorities to limit National Bank financing to the public sector to seasonal requirements only, in order to strengthen the Bank's liquidity position in 1985-86. Moreover, the increased reliance on financing from bilateral and multilateral sources, including the proposed restructuring of maturities falling due under the Paris

Club, was expected to improve the term structure of external debt. Directors also noted the agreement reached with commercial banks aimed at restructuring obligations falling due and at providing moderate amounts of access to additional resources over the period 1985-86.

Directors underscored the need to implement promptly the proposed modifications in the structure of incentives, in order to attain the required improvement in the allocation of resources and in the productivity and efficiency of the Panamanian economy. They noted the advances made with regard to commercial policies, and they urged the authorities to implement the envisaged reforms in the industrial, agricultural, and labor areas so as to speed up the redirection of resources toward sectors with comparative advantage in order to achieve a lasting strengthening of the economy and the current account of the balance of payments. They welcomed in this respect the intentions of the authorities to obtain support from the World Bank for these measures through a new structural adjustment loan.

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

The Executive Board then took the following decision:

1. The Government of Panama has requested a stand-by arrangement for the period from July 15, 1985 to March 31, 1987, for an amount equivalent to SDR 90 million.

2. The Fund approves the stand-by arrangement set forth in EBS/85/152, Supplement 1, and waives the limitation in Article V, Section 3(b)(iii).

Decision No. 8033-(85/107), adopted
July 15, 1985

2. DOMINICA - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Dominica (SM/85/173, 6/20/85). They also had before them a report on recent economic developments in Dominica (SM/85/184, 6/28/85).

Mr. Leonard made the following statement:

Since the previous Board discussion of Dominica the authorities have further consolidated the gains made after 1980 in strengthening the public finances, moving toward external balance, promoting investment, and raising output. The prospects for continued progress in the medium term are encouraging, provided that the present firm management of the economy continues and is complemented by substantial concessionary aid from abroad and improvements in trading conditions.

The growth of real GDP accelerated to over 4 percent in 1984 and appears set to continue at about the same rate in 1985. Inflation has fallen from the high levels of the opening years of the decade and, despite some quickening of the 2.2 percent rate recorded in 1984, is expected to remain moderate for some time to come. In the external account, the current balance remains negative but manageable and the overall balance is now positive. There are also indications that the unemployment rate--according to some rough estimates as much as 18 percent in preceding years--fell in 1984 as a result of greater investment spending.

In the fiscal area, the current account balance of the Central Government moved from a continuing deficit to a small surplus in 1983/84. In 1984/85 a further modest advance was made. Savings were higher than in the previous year but, because of unforeseen expenditures on pension benefits, interest charges, and repairs of storm damage, fell short of what was envisaged in the Fund stand-by arrangement approved in July 1984. The Government sought to meet the extra expenditure by cutbacks elsewhere in the budgetary provisions. However, as revenue was also less than expected, the scope for cuts was insufficient to bridge the gap, and recourse to borrowing which breached the conditions of the stand-by arrangement was necessary. In moving toward current fiscal balance, current expenditure has been reduced from 39 percent of GDP in 1980/81 to 31 percent of GDP in 1984/85 and the tax burden has been increased by 2 percentage points to bring total current revenue again to about 31 percent of GDP. Lower transfers to the public enterprises have contributed mainly to the containment of Government's current spending and were made possible by better management of the enterprises and increases in their tariffs and charges.

Government capital spending has been on a rising trend since 1981/82 and was the equivalent of over 21 percent of GDP in the past fiscal year. Most of this expenditure has been supported by external grants and concessionary borrowing. Developments in the central government accounts have been reflected in those of the public sector as a whole. In this area the current balance has also moved from deficit to surplus, and capital spending, financed on concessionary terms from abroad, has grown as a proportion of GDP.

The present phase in the management of the economy is part of the authorities' continuing efforts to secure the base for future growth and better living standards. The authorities fully appreciate the importance of investment in that process, the extent to which it is at present dependent on favorable external financing, and the vulnerability of the overall external balance to any falling-off in such inflows of funds. They accept, therefore, that while they must seek to maintain the inflows at as high a rate as possible for as many years as possible, the capacity of the economy to generate its own savings must also be maximized. Their approach to the budgetary dispositions for 1985/86 as discussed with the staff has been influenced accordingly.

It was envisaged in the course of the consultations that government savings should increase markedly, and that investment expenditure should rise both absolutely and in terms of GDP and, as in the past, would be mainly financed by foreign grants and concessionary loans. It was also envisaged that there might be some borrowing from commercial sources and from the Social Security Scheme; all obligations to the IMF would be met. Critical to this outturn would be tight containment of the growth of the Government's pay bill, which would be sought through moderation in pay rates and action on the number of persons employed. At present, pay negotiations are not yet completed and the implications for the public finances are not known. Depending on the outcome, the Government's general fiscal approach may need revision in the actual budget for 1985/86, which has yet to be settled following the Government's recent return to office after a general election.

In the light of fiscal intentions, official grant expectations, prospective public sector borrowing, and other capital movements, the balance of payments seems likely to develop satisfactorily in the period immediately ahead. This year the current account deficit as a proportion of GDP should remain close to the 1984 figure of 9 percent before falling to a lower figure in 1986. A small overall surplus could accrue both this year and next so as to cover net repayments to the Fund and small increases in reserves. As in the past, the future evolution of the external accounts in both the short term and the medium term will largely turn on the flow of concessionary finance and in that regard will require the continuing attention of the authorities.

An acceptable outturn of the external accounts over the medium term will also depend on a significant growth of exports. The foundations of such growth are being prepared through the investment program drawn up by the authorities in consultation with the World Bank and major donors of funds. The program will provide valuable additions to infrastructure, help to diversify agriculture, and extend the industrial base, but if it is to yield its full benefits, it will need to be complemented by more directly productive private investment. In this connection, the authorities accept the need to ensure that adequate domestic credit is available to private borrowers and that public sector demands are contained accordingly. There is no problem at present but the issue could become pressing if public savings are not generated on an adequate scale.

The authorities are also aware of the potential danger to competitiveness and, therefore, to private investment arising from the appreciation for some time past of the common currency that Dominica shares with other members of the Eastern Caribbean Central Bank. Dominica is following closely the joint review of the exchange rate of the Eastern Caribbean dollar in which it has been an active participant. In the meantime it is the authorities' intention to press for pay restraint in keeping production costs at their present attractive level.

Although last year's stand-by arrangement is not now operational, the authorities look forward to continuing good relations with the Fund. They have asked me to convey to the staff their appreciation of its counsel, practical assistance, and courtesy in the course of the consultations.

Mr. Hospedales observed that Dominica's recent economic performance demonstrated that strong and determined adjustment efforts were required to overcome the very difficult economic and financial problems besetting small island states which had deficits in the government accounts and balance of payments and which were highly vulnerable to external shocks. He was in general agreement with the staff's balanced analysis and had taken note of Mr. Leonard's statement underscoring the commendable achievement of the Dominica economy subsequent to the damage caused by the 1979-80 hurricanes. The reconstruction and rehabilitation efforts pursued under two Fund-supported adjustment programs, together with other sources of external financing, had undoubtedly laid the foundation for self-sustained medium-term development. Continued inflows of external resources in adequate amounts would be crucial for the continued pursuit of those efforts. Real GDP growth was averaging 3 percent a year; both the public sector finances and the balance of payments had strengthened significantly; and the inflation rate had receded to approximately 2 percent a year.

The cornerstone of the economic program had been a strong fiscal package, Mr. Hospedales noted. The shift to a surplus in the Government's current account had reversed the historical trend of deficits. Current expenditure had had to bear the brunt of adjustment and had been approximately 8 percent of GDP over the previous four years. The other main elements of the strong fiscal package, which had been adopted under difficult circumstances, included new tax measures and stronger tax collection procedures as well as an appropriate incomes policy. The latter policy should be continued because it would permit a further improvement in public sector savings. The positive real interest rate policy being pursued would no doubt raise national savings and ensure that the savings-investment gap, which at present was 22 percent of GDP, would continue to be narrowed. Dominica's dependence on external resources therefore would remain high for some time. He hoped that aid donors and multilateral institutions would continue to provide the net capital required to permit the expansion of investment. In the process, Dominica would become less vulnerable to external shocks.

Despite the satisfactory economic performance, Dominica had been unable to avail itself of two scheduled drawings under its current stand-by arrangement, in the amount of SDR 403,000, owing to noncompliance with two performance criteria, Mr. Hospedales remarked. The ceiling on government use of nonconcessionary financing and a subceiling on borrowing from the Eastern Caribbean Central Bank had been set in an attempt to ensure that resources were available for private sector expansion in 1984. He asked the staff whether the decelerating rate of growth of private sector credit in 1982/83, and the decline in private investment, which had averaged 11 percent of GDP in the same period compared with 15 percent in 1981, had resulted from the Government's pre-emption of an undesirable share of domestic savings. If not, could the staff explain the rationale for those performance criteria? Furthermore, the noncompliance with the performance criteria seemed to have had more to do with Dominica's response to the damage caused by the November rainstorms, a factor clearly beyond the authorities' control, and the consequent need to increase capital expenditure rather than to any lack of steadfastness in honoring its commitment to the Fund. The staff might wish to explain why a country like Dominica should not have benefited from a waiver of the performance criteria in those circumstances. He asked the staff whether it considered Dominica to be overindebted.

The recent weakening of the balance of payments, in particular the 7 percent fall in exports in 1984, provided ample evidence of the difficulties involved in the adjustment of structural imbalances, which in Dominica emanated from the supply side, Mr. Hospedales said. It was widely recognized that in such a situation, changes in the pattern of production were necessary, calling for substantial new investment in export-production and import-substitution activities and measures to keep exports competitive. The rationalization of the banana industry and the present policy of pay restraint were steps in the right direction. The public sector investment program, which envisaged capital expenditure approximating 27 percent of GDP over each of the next two years, should be implemented as a matter of priority.

Ms. Bush remarked that Dominica had made progress in a number of areas over the past four years. The notable achievements included an increase in the real rate of economic growth and a substantial reduction in the rate of inflation. Furthermore, the number of public sector enterprises had been reduced significantly and the financial position of those remaining had been strengthened. Those gains would have to be consolidated through the implementation of policies that would assist Dominica in continuing along the path of economic growth while increasing private sector activity.

It was unfortunate that fiscal problems had caused Dominica to miss meeting some of the ceilings contained in the 1984 stand-by arrangement and the program to fall off track, Ms. Bush continued. Many of the goals of the program remained essential to any further expansion of Dominica's economy, particularly the objective of further improving government savings to support the investment program, which would help in turn to encourage private sector growth through the development of infrastructure and the increased availability of credit to the private sector.

The medium-term balance of payments outlook in the staff report was a helpful tool for analyzing Dominica's policies and economic prospects, Ms. Bush considered. It seemed important that the authorities should seek new ways to curb government expenditure in order to be able to refrain from nonconcessionary borrowing, which reduced the availability of credit to the private sector and could hinder overall economic growth. In addition, the authorities should follow through with their plans to pursue a cautious wage policy. No increase in wages for civil servants had been included in the 1985/86 projections of government expenditure, and any additional wage costs under present circumstances would have an adverse effect on the improvement in the overall fiscal position of the Central Government.

The World Bank was assisting Dominica to develop its overall investment program, Ms. Bush observed. The development of infrastructure in the agricultural and industrial sectors of the economy was certainly essential, and she would be interested in knowing what specific measures were contemplated in that respect in the investment program. She also wondered whether the staff could elaborate on the measures that the authorities would take to stimulate foreign private sector investment, the need for which was also emphasized in the investment program.

Dominica's debt service burden had grown substantially, Ms. Bush noted, and the country needed concessional aid to finance its overall balance of payments deficit. It was regrettable that the exchange rate study being carried out by the Eastern Caribbean Central Bank had not yet been completed, especially as the exchange rate for the Eastern Caribbean dollar had had a negative effect on some of Dominica's exports. Because the Dominica authorities did not have the option of exchange rate action in order to attain a more sustainable balance of payments position without having to resort to nonconcessional aid, they should review the 1985/86 budget to make whatever cuts in expenditure were needed, particularly in wages.

Mr. Clark noted that Dominica had made substantial efforts over recent years to improve its economy in the face of some serious setbacks, especially from natural disasters. Progress had been made in particular toward the diversification of agriculture and the development of the manufacturing sector. It was also worth quoting the staff comment that the public enterprises "have required virtually no transfers from the Central Government after FY 1980/81 because of better management, reductions in subsidies to farmers, and increases in water rates and seaport charges." Unfortunately, there had been some less encouraging developments, notably the fiscal and external slippages in 1984/85, which had been reflected in the breakdown of the stand-by arrangement approved in July 1984.

If past progress and further economic recovery were not to be jeopardized, firmer and prompt action would have to be taken in two areas in particular, Mr. Clark considered. First, it was necessary to bring public spending under better control. Current expenditure would have to be restrained by limiting pay increases and the growth of the overall public sector pay bill. Also, overruns on unbudgeted expenditure on pension fund and interest payments had occurred, and he asked the staff why those items had been unbudgeted and whether such overruns were likely to happen again. The rise in capital expenditure in 1984/85 seemed to have been mainly responsible for the increased fiscal deficit and the authorities should therefore aim at pacing expenditures more carefully so that they were wholly or largely covered by concessional finance or domestically generated savings. The World Bank should be able to help in that process by establishing clear priorities.

The second area calling for attention concerned external policy, Mr. Clark remarked. Like Ms. Bush, he had been disappointed to learn of the delay in producing the Eastern Caribbean Central Bank's review of exchange rate policy; he would be interested to know the target date for its completion. The structure of Dominica's trading relationships was perhaps somewhat different from that of its Caribbean neighbors in that it relied more on European markets and rather less on the U.S. market. To that extent, the pegging of the Eastern Caribbean dollar to the U.S. dollar seemed to have had a particularly serious effect on the competitiveness of the Dominica economy. Finally, the staff's medium-term projections, which incorporated a doubling of export revenue over the five years ahead, seemed optimistic. The external accounts were likely to come under greater pressure than those projections suggested, reinforcing the need for restraint in domestic spending and for a more appropriate exchange rate.

Mr. de Forges said that he agreed with the thrust of the staff appraisal. Indeed, the recovery of the Dominica economy since the catastrophies of 1979 had been remarkable and had proved the determination and the ability of the people and the Government to sustain a major adjustment effort. However, it was time for the objective of achieving short-term recovery to give way to that of attaining sustainable growth in the longer run. The growth of the economy could be achieved through the improvement of productive capacity, particularly for manufactured goods with good export prospects. For that purpose, the public investment program appeared both realistic and moderate; the program had of course benefited from World Bank assistance, but it could not be expected to yield either rapid or spectacular results; on the contrary, the authorities had a difficult road ahead of them.

Even though some major improvements had been recorded, much remained to be done, Mr. de Forges noted. In both the fiscal and external sectors, earlier efforts had to be continued and reinforced, in particular the attempts to increase domestic savings and to broaden the export base. Thus, it was regrettable that, after four years of compliance with the terms of Fund-supported programs and successful endeavors in laying the groundwork for balanced future growth, unexpected events had led to deviations from the performance criteria and suspension of Fund assistance to Dominica.

Obviously, specific and external constraints limited the effectiveness of the Dominica authorities' decisions, Mr. de Forges remarked, from climatic conditions to participation in a regional monetary arrangement with a currency that tended to be overvalued from several viewpoints. However, the Government that had recently been confirmed in office had some major winning cards in hand. The authorities should be able to correct recent slippages and follow through with the efforts undertaken already, especially the wage negotiations with civil servants and the need to maintain an adequate level of capital spending. It might then be possible to reverse the deterioration of the current account and lighten the public debt burden, thereby improving Dominica's chances of successful adjustment.

The staff representative from the Western Hemisphere Department explained that there had been no explicit ceiling on borrowing by the Government from the local commercial banks. Such borrowing was part of nonconcessionary financing, which was subject to a ceiling, and thus it was indirectly subject to certain restrictions. To meet the overall ceiling on nonconcessionary borrowing, it might become necessary for the authorities to offset borrowing from the local commercial banks by borrowing less from other sources or repaying loans. In 1981/82, when the Government had borrowed substantial amounts from local commercial banks--in an amount equivalent to 2.5 percent of GDP--private sector investment had contracted significantly. At that time, the Government had decided to reduce its reliance on such credit, as developments in the subsequent two years showed, including the program under the stand-by arrangement.

Both the nonrecurrent nature of the capital spending associated with the November rainstorm and nonbudgeted current expenditure by the Government had been discussed with the authorities during the midterm review, the staff representative noted. At that time, the authorities had wished to seek a waiver of the existing ceilings as well as a major adjustment in the ceilings for the remainder of the program period. The staff had been willing to accommodate the authorities' wishes with respect to noncurrent expenditure associated with the rainstorm, but they had wanted to go much further by raising the ceiling to cover other government expenditure, which the staff considered inconsistent with the objectives of the program. The risk of an unsustainable financial position of the Government would have been increased and the revolving nature of certain facilities offered by the Eastern Caribbean Central Bank to its member countries would probably have been jeopardized.

The Dominica Government was putting great emphasis on the role of the private sector in its development strategy, the staff representative went on. One of the major objectives of the public sector investment program itself was to improve the infrastructure, with the hope of attracting foreign private investment as well as domestic investment. In addition, the Industrial Development Corporation and the Agricultural Industrial and Development Bank had been set up to assist the private sector in establishing manufacturing units. The Government was also currently bolstering its efforts to assist the private sector in seeking new export markets.

The overruns on nonbudgetary expenditure had had two main sources, the payment of pensions and gratuities and rather small interest payments, the staff representative explained. The Government had found itself obliged to make lump sum payments to a large number of civil servants who had retired suddenly for no clear reason. In future, civil servants who wished to retire in a given year would have to inform the Government in advance so that the lump sum payments due to them could be included in the budget. Overruns on interest payments had resulted from the failure to record certain debts properly.

No target date had been set for the completion of the exchange rate study, the staff representative said. So far only Dominica and Antigua and Barbuda had completed their part of the study; other member countries of the Eastern Caribbean Central Bank (ECCB) were in the process of doing so. The Fund was providing technical assistance in that matter. The Monetary Council of the ECCB was to have met in April 1985 to review the exchange rate study but it had postponed its meeting due to lack of government participation. The meeting was expected to be rescheduled for August.

Export projections were of course fraught with uncertainty, especially in a one crop economy that had a very small manufacturing base, the staff representative from the Western Hemisphere Department noted. Exports of both bananas and soap had not been doing well in 1984. However, new manufacturing units that were primarily export oriented were beginning to come on stream. Banana output should increase substantially in the future based on the greater use of fertilizer and improvements in fill packing. Prospects for the soap industry were also supposed to improve gradually as market conditions became more satisfactory. The Government was seeking new outlets for its other agricultural products, such as citrus fruits, in negotiation with the Puerto Rican Government and the private sector. The projected rate of growth of exports of 15-16 percent in 1985 from the depressed level of 1984, falling gradually to about 10 percent in nominal terms, was broadly consistent with those assumptions.

The Deputy Director of the Exchange and Trade Relations Department observed that Fund policy and practice in granting waivers was a matter of whether the problem was temporary or minor and not a question of whether or not ceilings had been breached for reasons that were outside the control of the member. It was the staff judgment that the excesses over the ceilings in Dominica's stand-by arrangement had been neither temporary nor minor.

Although Dominica's external debt/GDP ratio in terms of U.S. dollars was on the high side, it would be hard to claim that Dominica was over-indebted, the Deputy Director noted. Debt service in terms of exports of goods and services would be about 11-12 percent in the few years ahead, less high than in a number of other countries. It was noteworthy however that Dominica's debt service to the Fund over the same period--US$2 million to US$2.5 million--accounted for about 50 percent of the total debt service burden, a legitimate cause for concern.

Mr. Leonard stated that the Dominica authorities were making a strong effort to put the economic affairs of the island on a basis that would allow sustained growth in the future. For the most part, economic indicators were running in the right direction although perhaps not quite as fast as might be wished. However, Executive Directors had recognized both the significance of the economic turnaround and the fact that the adjustment effort would be neither easy nor quick, given the slender resources available.

It was always a cause for disappointment when a stand-by arrangement lapsed, Mr. Leonard remarked, but too much should not be made of the circumstances underlying Dominica's inability to observe two ceilings under its stand-by arrangement. None of the various ways discussed by the authorities with the staff for meeting the ceilings had offered any easy way to tighten the screw of adjustment further. The burden on taxpayers in Dominica was perceived to be higher than that in other member countries of the Eastern Caribbean Central Bank. Public expenditure had been closely curtailed for some time. Additional adjustment might have meant a real hardship for many people and its timing might have been unfortunate for the continuation of the adjustment effort over the longer term owing to the pending election. The authorities had accepted with regret that they could not reach an agreement with the Fund, though not for lack of goodwill or effort on either side. The Dominica authorities looked forward to good relations with the Fund in the future.

The exchange rate study being undertaken by the Eastern Caribbean Central Bank was continuing, Mr. Leonard concluded. However, he did not envisage any change in Dominica's exchange rate in the immediate future.

The Chairman made the following summing up:

> Executive Directors generally agreed with the staff appraisal in the report for the 1985 Article IV consultation with Dominica.
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> Directors noted the continued expansion of real GDP and the reduction in the rate of inflation in 1984, and stressed the need to consolidate the progress made in recent years in areas such as

agriculture and the development of manufacturing. The vulnerability of the small island economy of Dominica to external factors and its continuing dependence on external financing were emphasized. Directors were disappointed that under the last stand-by arrangement Dominica had failed to comply with performance criteria regarding the Government's use of nonconcessionary financing and borrowing from the Eastern Caribbean Central Bank. They stressed the need to improve the fiscal position and expressed concern over the likelihood of a further significant use of nonconcessionary financing by the Central Government in the period ahead.

Directors welcomed the World Bank's role in assisting Dominica in the assessment and also the financing of the investment program but emphasized that the full implementation of such a program was dependent on a sizable increase in public sector savings. They stressed the urgent need to contain the growth of government current expenditure and to raise revenue. Otherwise, capital spending would have to be stretched out in order to ensure a manageable overall fiscal position, and thus avoid compression of bank credit to the private sector.

Directors noted the adverse implications for the external sector of the increase in the real effective value of Dominica's currency over the past four years. They urged the authorities to press for an expeditious conclusion of the current review by the Eastern Caribbean Central Bank of the exchange rate of the Eastern Caribbean dollar. Directors also drew attention to the rise of real wages in 1982-84, and they emphasized that the new wage settlement with the civil servants should take into account not only the need to strengthen public finances but also the effects on the country's international competitiveness and the profitability of investment.

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

APPROVED: April 10, 1986

LEO VAN HOUTVEN
Secretary