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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/127

10:00 a.m., August 28, 1985

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	A. K. Diaby, Temporary
C. H. Dallara	E. L. Walker, Temporary
	H. G. Schneider
B. de Maulde	
	T. Alhaimus
H. Fujino	M. Sugita
	H. Kobayashi, Temporary
	K. Murakami, Temporary
G. Grosche	
J. E. Ismael	Jaafar A.
R. K. Joyce	
A. Kafka	
	O. Isleifsson, Temporary
E. I. M. Mtei	A. Abdallah
F. L. Nebbia	B. Jensen
Y. A. Nimatallah	
P. Pérez	
	J. de Beaufort Wijnholds
C. R. Rye	
	O. Kabbaj
A. K. Sengupta	
	T. A. Clark
S. Zecchini	N. Coumbis
Zhang Z.	

J. W. Lang, Jr., Acting Secretary
J. Bungay, Assistant
L. Collier, Assistant

Also Present

IBRD: R. González Cofino, Latin America and the Caribbean Regional Office. Asian Department: P. R. Narvekar, Deputy Director; U. Baumgartner, R. A. Feldman, R. Kibria, D. M. Ripley, A. Salehizadeh, R. C. Williams. European Department: L. A. Whittome, Counsellor and Director. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; E. H. Brau, Y. Boutros-Ghali, J. A. Buyse, M. Fisher, R. L. Sheehy. External Relations Department: H. O. Hartmann. Fiscal Affairs Department: C. A. Aguirre, R. S. Latham. IMF Institute: D. H. Rarawa, Participant. Legal Department: A. O. Liuksila, S. A. Silard. Research Department: W. C. Hood, Economic Counsellor and Director. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; H. Ghesquiere, T. M. Reichmann. Advisors to Executive Directors: P. E. Archibong, J. Hospedales, P. Péterfalvy, G. W. K. Pickering, E. M. Taha, D. C. Templeman, A. Vasudevan. Assistants to Executive Directors: J. R. N. Almeida, W.-R. Bengs, J. de la Herrán, J. J. Dreizzen, C. Flamant, R. Fox, S. Geadah, V. Govindarajan, N. Haque, G. D. Hodgson, Z. b. Ismail, R. Msadek, J. A. K. Munthali, D. J. Robinson, J. E. Rodríguez, M. Sarenac, L. Tornetta, A. J. Tregilgas, B. D. White, Yang W.

1. BHUTAN - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Bhutan (SM/85/216, 7/31/85; and Cor. 1, 8/1/85). They also had before them a report on recent economic developments in Bhutan (SM/85/220, 8/8/85).

The staff representative from the Asian Department informed the Executive Board of changes in the staff report and the report on recent economic developments in Bhutan.1/ The changes did not affect either the medium-term projections or the staff's appraisal.

Mr. Sengupta made the following statement:

When the last consultation report was discussed in the Board in 1983, Executive Directors commended the authorities' prudent financial policies, decentralization effort and favorable policies toward the growth of the private sector. There has not been any policy shift since then, and the authorities had pursued their objective of improving the material living standard of the people consistent with the maintenance of social harmony and environmental integrity.

The performance of the Bhutanese economy in recent years has been very satisfactory. Real GDP has grown by more than 6.5 percent per annum in 1983-85. For 1985/86, the projected growth rate is 7.0 percent. Agriculture and forestry, representing 60 percent of the total weight in GDP, had performed well in the last two years, after a drought in 1982/83. Production of cereals, fruits and other major crops, especially the major cash crops, had shown appreciable increases, reflecting in part the impact of the programs to enhance agricultural productivity. Double cropping, intercropping, and use of high-yielding varieties are being encouraged. Model farms to disseminate information on improved farming practices, extension services, animal husbandry, veterinary services, and provision of leasing equipment to farmers during periods of acute shortage of agricultural labor are some of the other measures taken in recent years to effect improvement in farm productivity. Efforts are being made to extend rural credit through the banking system; this is reflected in the improvement in the bank advances to this sector in the past year.

Forestry, which accounts for about 10 percent of GDP and 10 percent of total exports, is largely state-owned. Forestry exploitation has been low and uneven due mainly to difficulties of terrain. Besides, for environmental reasons the Government

1/ See SM/85/216, Cor. 2, 9/4/85; and SM/85/220, Cor. 1, 9/4/85.

has been stressing the need for caution in exploiting forestry resources and instituting scientific forest management practices and reforestation schemes.

The industrial sector in Bhutan is small, contributing about 9 percent to GDP and consisting of simple consumer products (such as soap, liquor and candles) and a few intermediate goods (cement and chemicals). Two enterprises--one in the cement and the other in the distillery sector--are publicly owned, and the Government has a 10 percent share in a fruit products company. It is envisaged that in 1985/86, 20 percent of the shares of the Government's cement factory would be sold. Two major projects are in the pipeline--a cement plant with a large production capacity and a calcium carbide plant--the latter to be a joint venture between the Government, representatives of Bhutan's private sector, and foreign financing from Kuwait, Norway, and IDA. The Government has sought to promote industrial investment through the setting up of industrial estates for providing adequate infrastructure, and the provision of tax holidays and credit at fixed interest rates depending on the size of the operation. The licensing system for operation of industries is simple and handled quickly. Once the project is approved, the foreign exchange necessary for its implementation is made available. Government equity participation may be required in large projects.

Power generation and consumption in Bhutan are relatively small, a large part of requirements being currently met by drawing on supplies from the neighboring Indian states of Assam and West Bengal. The Chukha hydroelectric project was envisaged to generate 336 MW of power. The first of the four 84 MW generators at Chukha is expected to come into operation in mid-1986 with full capacity anticipated by the end of next year. Once the Chukha project becomes operational in 1986, there will be a dramatic rise in domestic electricity generation. The sales receipts from the use of electricity from the Chukha project are expected to be substantial.

Bhutan has followed extremely prudent financial and trade policies. Government revenues increased by about 64 percent in 1983/84--partly due to changes in the tax structure, introduction of a tax on net corporate profits and improvements in tax administration--whereas the rate of growth in expenditures was limited to about 14 percent. In 1984/85, the rate of growth in revenues was as high as 24 percent while the rise in expenditures was limited to little less than 15 percent. Current expenditure growth was kept under check, in spite of a rise in civil service salaries in 1984/85. Capital expenditures have been rising in recent years, reflecting the increase in spending for development purposes. Foreign grants averaged about 13 percent of GDP in recent years. This helped to keep the budget deficits under control, and in 1984/85 there was actually an overall budget surplus of Nu 12 million (0.3 percent of GDP). The budget for 1985/86, however, projects a deficit, which is expected to be fully financed by foreign loans. The authorities are aware of the pressures that could be placed on domestic resources by large increases in government expenditures, even though such outlays could be financed by external loans.

The Royal Monetary Authority has functioned as an autonomous entity since the end of March 1984. It has assumed the issue of the ngultrum and the management of the convertible currency reserves. The share of the ngultrum in currency in circulation has gone up. There has been evidence of increasing monetization. The interest rate structure is adequate to allow for an increase in domestic savings and for a rise in the flow of resources into domestic investment activities. There is an increasing awareness of the need to develop an institutional framework within which the financial sector can operate, as evidenced by the Royal Monetary Authority's assumption of the management of the rural credit scheme.

Trade with India, which provides the bulk of the market for Bhutan's exports and a large proportion of Bhutan's import requirements, is virtually unrestricted. Owing to the rise in the US$/Nu rate, the expansion rate in exports to India had declined in 1984/85 in dollar terms, but in rupee terms, exports continued to rise. Imports are largely tied to external assistance, primarily in the form of grants. Tourism, which could offer scope for generating convertible foreign exchange receipts, will be given its due importance, keeping in view its likely impact on the environment and traditional cultural values. While current account deficits had been substantial, the overall balance of payments had been one of surplus owing to large aid inflows, particularly grants. The convertible currency reserves are at fairly comfortable levels. The medium-term prospects, therefore, do not appear to be difficult. The authorities, however, are eager to diversify their export structure and markets, but high transportation costs are a major constraint in this effort. The ngultrum is freely convertible with the Indian rupee at par, and there are no subsidies or taxes on exchange transactions.

The authorities have begun to make the necessary preparations for formulating the Sixth Plan, to be initiated from 1987-88. The exact size and composition of the Plan have not yet been established. Decentralized planning is expected to be taken further in the Sixth Plan.

My authorities greatly appreciate the help received from international organizations for diversifying the economy. They also value the advice and policy guidance received from the Fund and the World Bank.

Extending his remarks, Mr. Sengupta observed that the staff had improved the data base of Bhutan greatly and had thereby provided estimates that the authorities themselves would have had difficulty providing.

Mr. Murakami observed that the recent performance of the Bhutanese economy appeared satisfactory. Real GDP growth had averaged over 5 percent a year in the past five years; if fiscal year 1982/83, when Bhutan had suffered from a severe drought, were excluded, the recent growth rate would be 6-7 percent a year. In addition, Bhutan's overall balance on external account had been in surplus and the ratio of both the external debt and the debt service to GDP remained at a low level. That satisfactory performance was the result of the authorities' cautious and pragmatic financial and external debt policies, and in a longer-term context, their philosophy of self-reliance--interpreted, in part, as decentralization of the development effort and privatization of certain activities of the public sector.

The growth of the Bhutanese economy, however, was constrained by factors such as the scarcity of both skilled and unskilled labor and significantly weaker export growth in recent years, Mr. Murakami continued. The medium-term scenario indicated that the debt service ratio in convertible currencies would rise significantly in the three years ahead, reflecting large disbursements for capital projects. Moreover, substantial deficiencies in the statistical base of Bhutan remained. Those considerations posed a certain degree of uncertainty, albeit not an immediate threat, to the future of the economy. He therefore broadly endorsed the staff appraisal and supported the proposed decision.

The authorities had achieved their objective of financing the Government's current expenditures with domestic revenues well ahead of schedule by raising internally generated revenues and curtailing excessive growth in grant expenditure, Mr. Murakami noted. However, in view of the inevitable increase in capital expenditures in the coming years, further expenditure restraint, including the expected rationalization of the civil service salary structure, would be necessary. The authorities should simplify the current tax system and improve its administration.

He supported the authorities' intention to replace the Indian rupee with the ngultrum, Mr. Murakami said. Although no official statistics were available, the rupee was estimated to account for 65 percent of the currency in circulation; therefore, the current exchange rate policy of Bhutan, based on the maintenance of parity between the ngultrum and the rupee, seemed appropriate, although it limited the scope for monetary policy.

More efforts to encourage exports were called for in light of the Government's reluctance to promote tourism actively, Mr. Murakami commented. Establishment of the proposed agricultural marketing centers throughout the country could help provide adequate financial incentives to encourage agricultural exports. Within the constraints of high transportation costs, however, more emphasis could be placed on production and export of industrial goods in addition to the strategy of exporting high value-added agricultural commodities.

He agreed with the staff that Bhutan urgently needed to establish reliable statistical data for key economic indicators, including data on external debt, Mr. Murakami stated; he supported the Fund's technical assistance to that end.

Mrs. Walker noted that despite the formidable challenges Bhutan had faced in building the needed social and economic infrastructure, it had made substantial progress in several areas, particularly in growth, since its first Article IV consultation with the Fund in late 1982. The primary constraints on the development of the economy were the lack of skilled and unskilled labor and geographical conditions that hindered efforts to provide adequate transportation and electric power. In order to quicken the development process, efforts would have to be made to increase the involvement of the private sector. Its role in the development process had previously been small owing not only to external factors but also to the lack of credit extended by the commercial banking system to the private sector; government regulations requiring licenses for all investments; government equity participation in many projects; the preclusion of foreign equity participation in investments; high corporate income taxes; and a preferential interest rate structure. While the authorities' desire to use a well-defined investment plan involving substantial government participation as a major tool for development was understandable, she encouraged them to include measures in the plan that would promote private sector involvement.

The measures taken recently to strengthen the private sector--including the privatization of some public sector enterprises, the planned involvement of the private sector in new industrial projects during the period of the Sixth Development Plan, and the priority given to the private sector for the extraction of minerals--were welcome, Mrs. Walker said. The Government had set up industrial estates to provide adequate infrastructure for private sector enterprises, and further information on the success of that venture would be helpful. Certain industries had also been given tax holidays. Those steps were all in the right direction, but the authorities should expand private sector involvement further, perhaps by using tax holidays more extensively and by simplifying regulations on investment.

She wondered, in fact, whether government equity participation was essential to initiate new projects or whether the private sector could be encouraged to develop the projects alone, Mrs. Walker said. Although the authorities believed that foreign equity investment might endanger their objective of strengthening the indigenous private sector, some foreign participation would generate new industries that might not otherwise be created.

The constraint on export growth appeared to lie mostly on the supply side, Mrs. Walker commented. The agricultural sector would benefit from the new marketing centers and the new bank branches that could better meet its credit needs. Support prices for 1983/84 and 1984/85 had been set well below prevailing market rates, and the authorities should turn toward a more market-oriented pricing system to encourage supply. In addition, attention should be given to encouraging development in the industrial sector, since the domestic market for manufactures appeared limited.

She welcomed the graduation of the Royal Monetary Authority (RMA) to an autonomous entity in 1984, and she looked forward to its becoming a central institution in the field of monetary policy, Mrs. Walker said. The joint efforts made by the RMA and the Bank of Bhutan to promote entrepreneurship were commendable; a joint industrial finance unit might be useful.

The overall balance of payments position was comfortable, but the projections showed a substantial increase in the debt service burden in the next several years, Mrs. Walker concluded. In view of weaknesses in the statistical base, the authorities should request the technical assistance of the Fund in that area.

The staff representative from the Asian Department noted that the authorities were doing all they could to promote industrial development, whereas they were taking fewer measures than might have been hoped in the agricultural sector, with its prospects for high value added products that could be exported by air. Heavy industrial development was hampered by the costs of transportation between Bhutan and countries other than India.

At such an early stage of development, Bhutan was eager to do whatever it could to encourage private sector activities, the staff representative remarked. At present the loans from the Bank of Bhutan to the private sector were rather small, apparently because of a lack of demand, and the private sector was not in a position to undertake very large projects. Whereas the requirement for government participation in any industrial project did not in fact seem to be a binding constraint, the incentives for the private sector to make such investments were weak. Without government participation or investment many projects were unlikely to be initiated.

The authorities were wary of foreign direct investment because of its possibly detrimental effect on private sector development, the staff representative explained. However, they would willingly consider cooperative arrangements of different types if specific, acceptable recommendations were made.

Industrial estates had been established primarily in southern Bhutan, where they had proved fairly successful, the staff representative from the Asian Department said in concluding. As the existing estates were nearing capacity, the authorities were thinking of establishing new ones, which were likely to be distributed more widely across the country.

Mr. Sengupta remarked that the authorities were keen for private enterprise to participate fully in the development of the economy, but that active government participation would be required at the current stage. Participation by the public and private sectors should be viewed not as mutually exclusive but rather as complementary. For example, when fully operational, the Chukha Hydroelectric project would provide the energy required to create an infrastructure appropriate for increased industrialization. The weight of most of the mineral-based products precluded marketing them beyond the neighboring states because of high transportation costs. Nonetheless, the mineral resources of Bhutan, coupled with an enhanced power supply, should enable the authorities to develop a number of new projects.

The authorities retained an open mind on foreign equity participation, and they would be willing to permit it whenever it could contribute to Bhutan's growth, Mr. Sengupta added. Similarly, government equity participation was currently essential in large projects but not for small ones and industrial estates.

Finally, Mr. Sengupta said, the authorities had pointed out that the estimate of $250 per capita income of Bhutan had been made by the Fund; in view of the weakness of their statistical data base, they had requested that the estimate be used with caution.

The Acting Chairman made the following summing up:

> Executive Directors expressed agreement with the thrust of the staff appraisal. They commended the Bhutanese authorities for their cautious economic policies which had been instrumental in the maintenance of financial stability, a sound external position, and economic growth. The continuation of prudent financial policies, including careful management of external debt, would provide a framework within which to pursue their development strategy. In this regard, speakers welcomed the intention of the authorities to strengthen the role of the private sector in the development process, as indicated by the privatization of certain public enterprises and the stress on decentralization. It was recognized that Bhutan would continue to need significant inflows of highly concessional financial assistance, which have been provided by India and other members of the international community.
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> Despite the present and prospective strength of international reserves, concern was expressed about the weak export performance in recent years and the very narrow base for exports to the convertible currency area. In view of the expected rise in the debt service burden in convertible currencies over the

medium term, the Bhutanese authorities were urged to pursue a more active export promotion policy. A strengthening in export performance was seen as essential to ensure the imports necessary for Bhutan's development strategy. However, the continuation of present exchange arrangements seemed appropriate in the circumstances.

The Bhutanese authorities were encouraged to continue their cautious and pragmatic approach to monetary and fiscal policies. Regarding monetary policy, the authorities were encouraged to continue the transition from a system based on the Indian rupee to one based on the ngultrum. With respect to fiscal policy, the authorities were encouraged to restrain the growth of government salaries and to improve the tax administration base.

It was considered that investment projects should be reviewed carefully, taking into account the country's potential earnings of foreign exchange and the implications of project financing for the debt service burden. With respect to investment, Directors who spoke encouraged a further relaxation of restraints and regulations on private investment, including the existing requirements for government equity participation. It was also suggested that foreign investment might serve as a source of financing for needed industrial development within Bhutan.

While speakers recognized the constraints faced by the authorities in availing themselves of technical assistance in the statistical field, they nonetheless stressed the importance of a current and accurate data base so that policy implementation and economic developments could be satisfactorily monitored. In this connection, Fund technical assistance in this area was suggested as being potentially helpful to the authorities.

It is expected that the next Article IV consultation with Bhutan will be held on an 18-month cycle.

Mr. Sengupta suggested that summings up generally should perhaps not use the words "the Executive Directors..." when only a few speakers had intervened; words like "it was felt..." would more accurately reflect the views of those who had spoken.

The Acting Chairman noted that it was difficult to sum up a discussion when relatively few Directors had spoken. The normal approach was to assume that Directors who did not speak concurred with what had been said although summing up on that basis might be misleading. It was in light of Mr. Sengupta's concerns that an attempt had been made to reword the first draft of the summing up on Bhutan.

Mr. de Maulde said that Mr. Sengupta's remarks suggested to him that the Executive Board should perhaps formally review summing-up techniques, within the framework of surveillance procedures, to make certain that summings up were accurate reflections of the discussions.

The Acting Chairman said that the matter would be taken under consideration.

The Executive Board then adopted the following decision:

1. The Fund takes this decision in concluding the 1985 Article XIV consultation with Bhutan, in the light of the Article IV consultation with Bhutan conducted under Decision No. 5392-(77/63) adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The restrictions on the making of payments and transfers for current international transactions, as described in SM/85/220, are maintained by Bhutan in accordance with Article XIV and are not subject to approval under Article VIII. The Fund encourages the authorities to administer these restrictions in a liberal manner.

Decision No. 8061-(85/127), adopted
August 28, 1985

2. SOLOMON ISLANDS - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Solomon Islands (SM/85/215, 7/30/85). They also had before them a report on recent economic developments in Solomon Islands (SM/85/228, 8/14/85).

Mr. Rye made the following statement:

As with previous missions, there was a broad measure of agreement in this recent meeting, differing only in emphasis and interpretation in some grey areas where the data are inadequate. One such grey area is inflation. The authorities regard the Honiara retail price index as a defective guide to price movements in Honiara itself, and even more so for Solomon Islands as a whole. The index is unduly influenced by market vegetable prices (the situation is analogous to, though not as extreme as, the betel-nut effect in Papua New Guinea). Accordingly, my authorities do not share some of the staff judgments about inflation prospects.

Solomon Islands exemplifies many of the problems of low-income small-island economies. About 80 percent of the population maintains a traditional subsistence lifestyle. There is a chronic shortage of investment to underpin growth in the economy sufficient to improve the living standards of a rapidly growing (3.5 percent per annum) population. Although the export base is more diversified than that of many comparable economies, export returns are still subject to substantial ups and downs from year to year. In this very open economy, any excess demand tends to be reflected quickly in rapidly rising imports, putting pressure on external reserves. Because skilled administrators and experienced policy advisers are in short supply, there is sometimes a lag in recognizing and responding to changing economic circumstances.

Events of the past 18 months illustrate these difficulties: 1984 was a boom year for Solomon Islands. Extraordinary rises in prices of vegetable oils and timber boosted export returns by more than 50 percent. National income rose sharply, and the Government enjoyed an increase of nearly 40 percent in total budget revenues. By the end of 1984, however, prices were plummeting for all major exports except fish, and export receipts for the first half of 1985 were 16 percent lower than a year before. But imports continued to run high (up 15 percent on the same period), and the trade balance went from a surplus of SI$10.6 million to a deficit of SI$6.3 million.

Reflecting these and other developments, the financial performance of the Government in the first half of 1985 differed sharply from its stated intentions. The domestic borrowing of $10 million between mid-January and mid-July was about double what the budget envisaged for the whole year. The widening budget deficit was equivalent to about half the worsening in the balance of payments.

Manning problems at senior levels compounded the Government's difficulties in financial management and it was not until July that the following corrective measures could be put in place with ministerial support: improved monitoring, tighter expenditure control, cancellation or postponement of nonessential expenditure, strenuous efforts to collect all due revenue, and some increases in indirect taxation. The Government is now presenting substantially revised 1985 estimates to parliament, aimed at reversing the trends of the first seven months, narrowing the deficit on the recurrent budget to SI$2 million, and reducing the Government's net use of bank credit from SI$10 million at mid-year to about SI$5 million by the end of the year. This would put the Government's finances back on track.

On the monetary front, it had become clear during 1984 that high consumption expenditures would put pressure on bank credit and the external reserves as incomes fell in 1985. In anticipation of this, the Central Bank took a number of measures, including sterilizing SI$5 million of Copra Board reserves and raising the proportion of assets the banks were required to hold in liquid form from 15 percent to 25 percent.

In retrospect, it can be seen that more would have been needed to prevent an excessive expansion of credit, including that arising from government budget problems. However, additional measures have been taken in recent months.

In June the Central Bank raised its lending rate to the banks by 2 percent and asked the banks to raise interest rates on deposits by 2-3 percent, with an expected resulting rise in lending rates in the 1-2 percent range. On August 1 the Central Bank raised its lending rate to the commercial banks by a further 2 percent, again increasing pressure on lending rates. The Central Bank also raised the treasury bill rate by 1 percent and launched a new series of government bonds in June with 11 and 12 percent coupons to drain reserve money from the banks as well as to provide limited nonbank funding for the government's development budget. About $4 million has been raised in this way; of this SI$1 million was paid to the Government in August, and SI3 million is held outside the banking system by the Central Bank. When the monetary policy measures now in place take effect, the banks may be expected to reduce their use of Central Bank funds, with domestic deposits and total lending coming back to a more sustainable relationship toward the end of the year.

Solomon Islands external reserves are now fairly close to the level at which a drawdown of the balance of the Eurodollar loan would be made. However, in recent weeks there have been signs of returning stability in reserves (and in domestic credit) and the Central Bank is hopeful that it may be able to manage without a further drawdown.

More generally, however, the authorities recognize that Solomon Islands is facing adverse economic conditions and that the external help from a stronger world economy and higher export prices which saved a similar situation in 1981 are not on the horizon in 1985. The Government accepts that it must lead the way in putting the economy in order and not expect the private sector to shoulder the burden alone.

Extending his remarks, Mr. Rye observed that manning problems at senior levels had compounded the Government's financial management difficulties; in particular there had been neither a political nor an official head of the Finance Ministry in the first half of 1985. Following the change of Government in November 1984, the election of the appointed Finance Minister, Mr. George Kejoa, had been subjected to a legal challenge. After a long period of uncertainty, the matter had been resolved in a by-election, which Mr. Kejoa had won. Until Mr. Kejoa took office in late June, the Prime Minister had acted as Finance Minister for part of the period, which had naturally not been an entirely satisfactory arrangement. Meanwhile, the Permanent Secretary of the Finance Department, a most able administrator, had been obliged earlier in the year to leave office. It had taken many months to find a suitable successor. Unfortunately, economic and financial policy in the Solomon Islands had thus been hamstrung, because the first half of 1985 had been a period of rapid changes, and earlier action might have forestalled some of the difficulties that had emerged. However, the authorities were once again able to move in the right direction with determination, vigor, and a realistic appreciation of what had to be done.

Mrs. Walker noted that the economy of the Solomon Islands was affected by external factors similar to those facing many small island economies, most notably fluctuations in commodity prices. Even though Solomon Islands' exports were more diversified than those of many other Pacific islands, fluctuating commodity prices had had a major impact on the economy in 1984. Fortunately for the Solomon Islands, shortfalls in the production of vegetable oils in major exporting countries during 1984 had brought about a tremendous rise in the world prices for copra and palm oil. Consequently, in 1984, the Solomon Islands' terms of trade had improved by more than 30 percent; the overall fiscal deficit had declined by 7 percent of GDP since 1983; the current account deficit had declined from 13 percent of GDP in 1983 to 9 percent; and real GDP had grown by 15 percent. It appeared that those results had been better than expected in the Fund program, although the targets for inflation and the rate of investment had not been met.

The trend toward higher commodity prices during 1984 was expected to be partially reversed in 1985, Mrs. Walker continued. If the prices for copra and palm oil returned to more normal levels in 1985, the economy might not fare as well. To soften the effects of swings in those prices, the authorities should emphasize development planning in an appropriate medium-term framework, which would include a more adequate budgetary planning process that would allow the development of the necessary infrastructure, increase investment rates, and encourage the timely distribution of concessional foreign assistance. Development plans should also include provisions for contingencies based on alternative scenarios for commodity prices. In addition, use of World Bank technical assistance to help finalize and implement the Five-Year Development Plan would be helpful.

Private investment could also be encouraged through a sound development plan, Mrs. Walker suggested. While the new Foreign Investment Law was an appropriate move, the overall climate for private foreign investment was not favorable and would require the creation of incentives, including the development of a suitable infrastructure. Perhaps the staff could elaborate on other specific measures the authorities could take to encourage private foreign investment.

Projections for the external sector in 1985 and 1986, which reflected declining commodity prices, were not favorable, Mrs. Walker continued. The export sector needed additional incentives to increase production. The authorities had recently reaffirmed a key policy, the flexible exchange rate, which would help ensure the stable and continued growth of export production. The reduction in the duty on fish exports was welcome as a means to increase the financial strength of the fishing industry.

The Copra Board had played a major role in setting procurement prices high enough to elicit a favorable response from smallholders, Mrs. Walker noted. The purpose of the Copra Board, however, was to facilitate the development of the copra industry by stabilizing prices for the benefit of local producers of oil. The setting of prices must be timely and flexible to ensure that reserves would be used when world prices were low and built up when they were high, while achieving adequate overall producer support. She thus welcomed the Copra Board's recent steps to reduce producer prices in the face of declining world prices. Furthermore, if a similar fund were set up for cocoa, the authorities should administer it cautiously.

The authorities were encouraged to work toward improving their budgetary process, Mrs. Walker continued, particularly to include more realistic projections for current and capital expenditures. Could the Fund be of assistance in that area? Capital expenditure had been consistently lower than projected, whereas current expenditure had been much larger, primarily because of high wage increases that had not been anticipated in the budget. In light of the need to improve the fiscal position, she urged the authorities to adopt a more prudent wage policy. Efforts should be made to improve the financial position of the public sector enterprises; although some individual enterprises had experienced operating surpluses during 1984, the overall operating losses of public sector enterprises had increased substantially in 1984. An increase in the tariffs of some enterprises to reflect market prices would be a way to help reverse the deterioration.

The authorities' desire to make credit available to ensure adequate growth was understandable, yet an oversupply could exacerbate inflation and further weaken the overall balance of payments position, Mrs. Walker stated. The vulnerability of the external sector required a prudent credit policy, and the recent measures taken to control its expansion were appropriate.

In general, performance of the Bhutanese economy had been good, Mrs. Walker said. And if adequate attention was paid in the development plan to ways of easing fluctuations in the economy caused by commodity price swings, the economy should continue to fare well overall.

Mr. Kobayashi said that the generally favorable economic developments in the Solomon Islands in 1984 had been helped by the substantial improvement in the terms of trade. The increase in the value of exports by as much as 50 percent had contributed to the sharp reduction in fiscal and external deficits and to the rise in the growth rate. Optimism about the economic prospects had to be tempered, however, because the progress made had been derived largely from favorable short-run exogenous factors rather than from a better balanced economy resulting from the necessary adjustment.

During the course of 1984, financial policies had become rather expansionary, Mr. Kobayashi continued, partly reflecting the injection of liquidity through a large external surplus. Although the terms of trade had begun to deteriorate in the latter half of 1984, the policy stance had not yet been fully adjusted. As to the medium-term prospects, it would be of paramount importance to strengthen export capacity through sufficient investment spending and fuller utilization of foreign aid.

He endorsed the thrust of the staff appraisal, Mr. Kobayashi added, although there seemed to be some structural weakness in budget planning and expenditure control. In spite of the authorities' intention to achieve high levels of public investment, the share of capital expenditure had declined dramatically in the past few years, while current expenditure had persistently and substantially exceeded the budgeted amount. Fortunately, the Government was curtailing the use of bank credit, which had expanded substantially in the first half of 1985. However, stronger discipline was necessary to restrain the growth of salaries and the transfer payments.

The sharp decline in overall investment rates from nearly 35 percent of GDP in 1980 to less than 15 percent in 1984 was a matter of concern, Mr. Kobayashi said. Because shortages of skilled manpower seemed to be hindering project implementation and the full use of foreign aid, the authorities should strengthen their present policy of recruitment of expatriates. On the revenue side, as pointed out in the staff report, the authorities might be able to raise tax revenue by reducing the number of exemptions from import tariffs.

Although steps had been taken to restrain bank lending, Mr. Kobayashi observed, domestic credit expansion in early 1985 had still been excessive and warranted careful monitoring. In view of the expected decline in nominal income, rapid credit expansion would exert undue pressure on prices and the balance of payments. Also welcome were the recent successive increases in interest rates.

Copra production by smallholders had been quite elastic with regard to changes in export prices, Mr. Kobayashi noted. The production of other plantation crops had been much less elastic in the short term owing to higher fixed costs, but that did not necessarily imply low elasticity over the medium and long term; thus, adequate price incentives over the medium term would be important to strengthen export capacity.

He was pleased to note the resumption of the flexible exchange rate policy in recent months, Mr. Kobayashi added. Exchange rate policy should not respond to short-term fluctuations in terms of trade but should be guided by underlying trends in export profitability.

The authorities' intention to maintain a prudent debt management policy was welcome, Mr. Kobayashi stated in conclusion.

The staff representative from the Asian Department said that the authorities could take a number of measures to stimulate private foreign investment, which had indeed been weak in recent years. For example, an important macroeconomic measure open to the authorities was the provision of adequate and stable incentives throughout the commodity price cycle. Export incentives and export profitability in the early 1980s had been particularly weak, with marked improvement only in 1984. There had been some deterioration in export profitability in the first half of 1985, but it had been partially reversed by subsequent exchange rate action.

The disappointing performance of public investment in recent years had been reflected in the slow development of the infrastructure, the staff representative continued. Private foreign investment would respond positively to a better infrastructure, which the new development plan aimed to improve. In addition, if the Foreign Investment Law were to further liberalize conditions for work permits to be granted to expatriates, it would help to remedy the critical shortage of skilled manpower. The Solomon Islands had no problems with the repatriation of profits, dividends, or capital.

Land tenure was another complex matter, the staff representative added. The authorities maintained that the traditional pattern of land use had been adapted to changing economic circumstances, but some observers viewed that policy as a constraint. Finally, an acceptable candidate had been found in response to the authorities' request for technical assistance from the Fund in budget planning and control.

Mr. Rye noted that the authorities recognized the need for technical assistance from the Fund in the fiscal area. The Development Plan was also in need of improvement; past plans had been unrealistic, and the results had fallen short of projections.

As Mrs. Walker had observed, the Copra Board would have to achieve a fine balancing act to maintain a price that was adequate to evoke a supply-side response, but that would not lead to a depletion of copra reserves in a period of low prices, Mr. Rye remarked. A further sharp drop in the producer price was under consideration by the Copra Board for the near future.

The Acting Chairman made the following summing up:

Executive Directors were in agreement with the staff appraisal. It was noted that, with the terms of trade having improved by approximately 30 percent, economic developments in 1984 had been highly favorable to the Solomon Islands with a resultant strong growth in income and sharp reduction in the current account deficit. Speakers observed, however, that the immediate outlook for the balance of payments was less favorable. Export prices of vegetable oils were now substantially lower while the import volume was expected to increase in 1985, reflecting continued strong demand.

More generally, Directors who spoke noted that the Solomon Islands was an economy that was faced with fluctuating commodity prices; consequently, economic policies and strategy needed to be shaped accordingly. Concern was expressed about the recent large losses on copra operations, and the decision to reduce the producer price over the next few months was welcomed. A need was seen to establish clear objectives for the Copra Board's pricing policy, with the principal aim of the Board being to cushion producers' income against wide fluctuations in the world price.

It was noted that monetary policy had been too loose in 1984 and early 1985, and that the main objective for the remainder of 1985 must be to exercise tight control over bank credit. Speakers welcomed the recent measures designed to curb the banks' ability to lend and the increase in interest rates. It was suggested that credit market conditions would need to be kept under close review in order to assess whether further measures would be necessary. In view of weaknesses in budget planning and control, the recent slippage in tax administration and expenditure control, and the decline in the share of capital expenditures relative to current expenditures, it was observed that immediate improvements were needed in several areas of the budget process. The authorities were encouraged, in formulating the 1986 budget and beyond, to consider measures to strengthen revenue and to make every effort to restrain the growth of salaries and transfers. Speakers suggested that the authorities would need to provide realistic estimates of both current and capital expenditures so as to facilitate the budgeting process and the monitoring of fiscal developments. Directors welcomed the Solomon Islands authorities' request for technical assistance from the Fund in order to address these fiscal issues.

Recognizing that manpower constraints, as well as the absence of an appropriate medium-term framework, had impeded public investment, speakers commended the resumption of formal planning. They also pointed out the need for improvements in project identification as well as other administrative changes to enhance the use of foreign aid, which had fallen short of potential. Furthermore, the view was expressed that foreign investment could be given greater encouragement.

Speakers welcomed the resumption of a more flexible management of the exchange rate. It was noted that providing adequate price incentives over the medium term was a key element in ensuring continued growth of exports, and that the exchange rate policy should not be influenced by transitory factors affecting export prices. The authorities were commended for having taken advantage of the strong external position in 1984 to reduce foreign debt on commercial terms.

It is expected that, in view of the more difficult balance of payments situation, the next Article IV consultation with the Solomon Islands will be held on the standard 12-month cycle.

3. BRAZIL - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the restricted staff report for the 1985 Article IV consultation with Brazil (EBS/85/178, 7/31/85). They also had before them a report on recent economic developments in Brazil (SM/85/229, 8/14/85).

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/85/126 (8/26/85) and EBM/85/127 (8/28/85).

4. BELIZE - TECHNICAL ASSISTANCE

In response to a request from the Government of Belize for technical assistance in the tax field, the Executive Board approves the proposal set forth in EBD/85/220 (8/22/85).

Adopted August 27, 1985

5. REPORT ON INTERNATIONAL COMPILERS' WORKING GROUP ON EXTERNAL DEBT STATISTICS - RELEASE OF INFORMATION

The Executive Board approves the proposal set forth in SM/85/239 (8/20/85) to transmit the report on the meeting of the International Compilers' Working Group on External Debt Statistics held on June 12-14, 1985 to the other organizations that participated in the Working Group.

Adopted August 26, 1985

6. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 84/170 through 84/172 are approved. (EBD/85/216, 8/20/85)

Adopted August 27, 1985

7. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/85/223 (8/23/85) is approved.

8. STAFF TRAVEL

Travel by the Acting Managing Director as set forth in EBAP/85/224 (8/26/85) is approved.

APPROVED: May 14, 1986

LEO VAN HOUTVEN
Secretary