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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/160

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

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
A. Alfidja	Mawakani Samba
	M. Lundsager, Temporary
	E. L. Walker, Temporary
	L. Hubloue, Temporary
	S. de Forges
M. Finaish	T. Alhaimus
	H. Murakami, Temporary
	B. Goos
	J. Reddy, Temporary
	L. Leonard
	J. Hospedales, Temporary
	I. Puro, Temporary
	A. Abdallah
F. L. Nebbia	
	E. M. Taha, Temporary
	J. E. Rodríguez, Temporary
	A. Steinberg, Temporary
C. R. Rye	
	A. A. Agah, Temporary
	A. S. Jayawardena
	S. King, Temporary
	N. Coumbis
	Jiang H.

L. Van Houtven, Secretary
J. K. Bungay, Assistant

Also Present

Administration Department: R. M. Broadway. African Department: A. D. Ouattara, Director; A. Bourhane, E. A. Calamitsis, S. E. Cronquist, A. B. Diao, E. van der Mensbrugghe, S. M. Nsouli, B. R. H. S. Rajcoomar, A. Tahari, G. B. Taplin. Asian Department: Tun Thin, Director; R. J. Niebuhr, I. Otani. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; E. H. Brau. IMF Institute: R. R. Andely, Participant. Legal Department: S. A. Silard. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: L. K. Doe, G. Nguyen, J.-C. Obame, M. A. Weitz, A. Vasudevan. Assistants to Executive Directors: V. Govindarajan, N. Haque, A. R. Ismael, H. Kobayashi, V. Rousset, A. J. Tregilgas.

1. PEOPLE'S REPUBLIC OF THE CONGO - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with the People's Republic of the Congo (SM/85/241, 8/22/85). They also had before them a report on recent economic developments in the People's Republic of the Congo (SM/85/263, 9/23/85).

Mr. Alfidja made the following statement:

Following inflows of substantial oil revenue in the late 1970s and early 1980s, the Government of the Congo launched a five-year economic development program aimed at laying the basis for sustained economic growth. In this context, emphasis was placed on the development of the infrastructure and the diversification of the productive base of the country, to pave the way for continued economic expansion in the event of a major decrease of oil receipts. However, in recent years, the Congo has been experiencing serious financial difficulties. To arrest the deterioration of the finances of the country and steer the economy back to a healthy growth path, the Congolese authorities formulated, with the assistance of the World Bank, a multiyear structural adjustment loan (SAL) covering the period 1985-87.

Real GDP in 1984 rose by 2.5 percent, down from 3.5 percent in 1983, owing mainly to a weaker performance in the services and trade sector, with growth in the output of the oil sector remaining stagnant. For 1985, the projected decrease in the output of the oil sector is not expected to be compensated by significant gains in the non-oil sector. As a result, real GDP is forecast to fall by about 5 percent. In order to improve the performance of the agricultural sector--and by the same token the non-oil sector--emphasis is being placed on separating agricultural research activities, which will continue to be government supported, from directly productive ones. Consideration is being given to the possibility of transferring the management of some of the major agricultural enterprises to entities that will operate them under well-specified guidelines.

Concerning the parastatal sector, which accounted for 10 percent of GDP in 1984, its financial position weakened in 1984, although a significant improvement was recorded in the financial accounts of a number of them. This was a reflection of the steps taken to reduce the number of workers and the increase in prices of certain goods and services. However, in view of the increasing difficulties facing the public enterprises, the authorities have decided to implement, within the framework of the SAL, a set of measures aimed at rehabilitating them. In particular, the authorities have decided to reassess the social and economic importance of some enterprises and to liquidate nonviable ones. Overstaffing, which has been a problem over the years, is being tackled and in that respect the authorities have decided to re-examine and, if necessary, correct their recruitment policies. New hiring will be limited, and some employees may be dismissed or transferred to other private or public enterprises. The management of the public enterprises is also being improved through the introduction of modern management methods and the institution of a staff training program. Pricing procedures are under review, and it has been decided to require enterprises to improve their estimation of production and transportation costs.

With respect to investment policies, in the light of the emerging economic and financial difficulties, the Congolese authorities have decided to scale down future investment spending and stress the expansion of directly productive activities. In this vein, they have decided to initiate several measures, including the preparation of a specific list of projects to be executed; the postponement of some projects; and the imposition of a strict control on the implementation of the investment program. Furthermore, a system to monitor and control investment expenditures at the project level is being put in place, and the express approval of the Ministries of Planning and Finance will be required for any external borrowing. In order to reduce the burden of the investment budget on the public sector, private sector participation in the development of small and medium enterprises is being encouraged. The authorities are also reexamining the financial agreements or contracts whose conditions are found to be unduly onerous and reassessing some ongoing projects that seem exceptionally expensive or on which the rate of return seems to be inadequate.

Fiscal performance in 1984 was characterized by a decrease in the overall fiscal deficit--commitment basis--to the equivalent of about 6 percent of GDP, compared with deficits of the order of 12-14 percent of GDP recorded during each of the preceding two years. This evolution reflects a sharp deceleration of expenditure growth. Capital outlays were reduced in nominal terms both in 1983 and 1984, whereas the growth of current expenditure slowed substantially. A further fiscal adjustment is projected to occur in 1985, with the deficit forecast to decrease to the equivalent of 2 percent of GDP on account of the continued restraint in government spending coupled with improved revenue. Several measures involving a fundamental change of course are envisaged in the context of the SAL with a view to restoring discipline in the public finances. On personnel matters, the measures include the conduct of a census of the civil service on the basis of which salary payments and various allowances being granted illegally will be terminated, and retirement laws will be more strictly enforced. In the same vein, studies are being undertaken with a view to making recommendations on the policy of automatic hiring of college and university graduates into the civil service and on temporary leave from government service. Current transfers to several types of organizations will be reduced or terminated. Spending ministries are no longer authorized to make expenditure commitments without prior approval of budgetary appropriations. More fundamentally, an inventory of all government assets, in particular materials and supplies, will be undertaken in order to improve the basis for budgetary allocation. Budgetary appropriations will no longer be based on past projections, but on the real financial needs of the spending units. On the revenue side, taxes on imported substitutes for locally produced commodities will be raised, as will the rate of taxation of imported luxury products. More generally, tax laws will be more strictly enforced and only tax exemptions allowed under those laws will be granted. Such fiscal efforts are geared in the long run toward enhancing the tax base so as to generate enough non-oil revenue to cover current expenditure. The Congolese authorities are fully cognizant of the need to overhaul the tax system and streamline it if this objective is to be attained.

In the monetary sector, credit expansion is expected to decelerate considerably in 1985, after some expansion in 1984 on account of a sharp increase in borrowing by the Government. To reinforce the initiatives and efforts under way in the other sectors of the economy, a number of measures are being undertaken in the monetary field as well. They include much tighter enforcement of credit ceilings allowed to public enterprises, increased efforts to ascertain the creditworthiness of borrowers and the denial of additional requests for loans made by financially unsound public enterprises. Unless loss-making parastatals take steps to redress their situation and assure financial viability, their access to bank credit will be interrupted, and if necessary terminated.

In sum, my Congolese authorities are fully aware of the deterioration in the performance of their economy. In a move to ward off further pressures and re-establish the basis for a steady economic growth under conditions of improved fiscal and external positions, they have launched a program that not only presents an accurate diagnostic of the financial and economic problems but also stresses a reordering of policies. As such, it is the view of my Congolese authorities that this comprehensive and far-reaching program deserves international recognition. Their efforts under this program are unlikely to succeed unless foreign creditors, bilateral aid donors, as well as multilateral financial institutions demonstrate their cooperation by giving effective financial support to the country. My Congolese authorities are awaiting the materialization of this assistance in the very near future.

Mr. Steinberg observed that the slowdown of economic activity in the Congo during 1983 and 1984 had not been the result of a change in the Government's economic policy but the consequence of the limited availability of resources. The authorities had responded slowly to the changing circumstances and realities; it was only by mid-1985 that they had become aware of the magnitude of their economic difficulties and had decided to adopt an adjustment program.

The authorities' Five-Year Economic and Social Development Plan, the implementation of which had been interrupted by the lack of financial resources, had been criticized by the staff on account of its size as well as its substance, Mr. Steinberg continued. The Plan, which was ambitious and expansionary, had been based on higher projected oil prices, and 60 percent of the financing was to have come from foreign borrowing. Too much emphasis had been devoted to infrastructure projects that had only a remote and indirect bearing on production, particularly on the growth of the non-oil sectors. Although the guaranteed employment offered by the Government to all school graduates might have enhanced education, it might have also brought the public sector to the point of negative marginal productivity while making it almost impossible to control expenditures on wages. In 1985, in spite of the involuntary slowdown in the preceding two years, the Congolese economy continued to suffer from substantial internal and external imbalances, including a growing external debt and mounting debt service ratio, as well as accumulated arrears and very low reserves. Given the bleak prospects for the balance of payments and the Central Government's budget, as shown in the staff's medium-term scenario, it was not surprising that the authorities had recently decided to launch their own adjustment program.

He had been expecting to find a detailed description of the adjustment measures in the staff report, Mr. Steinberg stated. Instead, the report listed some general goals and measures, including the achievement of a sustainable fiscal situation, expenditure reductions, a wage freeze, reductions in budgetary transfers to the public enterprises, and revisions in the tax system. He agreed with the staff that the intended measures might not be sufficient to deal with the country's serious problems. For example, a wage freeze would not be feasible if current employment policies prevailed, nor could a reduction of budgetary transfers to the public enterprises be achieved before a serious rehabilitation effort had taken place. However, Mr. Alfidja's opening remarks were more encouraging.

As in many other countries, the public enterprises were a source of great concern because they dominated the manufacturing, modern agricultural, transportation, and utilities sectors, Mr. Steinberg went on. The 103 state enterprises that accounted for 10 percent of GDP in 1984 had a deficit of 3 percent of GDP, about the size of the Central Government's deficit. The public sector as a whole accounted for about half of the non-oil economy and about 70 percent of total employment in terms of the wage bill. The authorities seemed to have recognized that the public enterprises were a serious problem and were committed to rehabilitating them, but when and how that would be accomplished remained unclear. It was his understanding that the World Bank had been approached for help on the matter but that negotiations were still going on; perhaps the staff or Mr. Alfidja could provide information on any further developments.

Thus far, the authorities had not sought the Fund's financial support for their adjustment program, which nevertheless contained the basic elements of a Fund-supported program, Mr. Steinberg noted. Thus, the authorities must have had some other reason for not asking for Fund support. However, the key issue was the need to implement the adjustment, not whether the adjustment was supported by the Fund. He hoped that the Government of the People's Republic of the Congo would have the ability and the time needed to rid the economy of external and internal imbalances and structural distortions. Once the authorities had shown their determination by taking the proper mix of adjustment measures, they could expect their external creditors to extend their support as well.

The collection of statistics in the Republic of the Congo needed improving, Mr. Steinberg pointed out. Data presented in the staff report and in the report on recent economic developments were limited in scope and in quality, as the staff itself had acknowledged in Appendix III of SM/85/241 on statistical issues. The lack of data placed constraints on policymakers and could make the implementation and monitoring of any economic program very difficult. According to Appendix I, the Fund had not yet given the Congo any technical assistance on statistical matters. He could only assume that such assistance had not been requested, and wondered whether that was also a reflection of the Congo's attitude toward the Fund.

Ms. Lundsager noted that in the past year, a number of policy adjustments had been made in the Congo, although they did not appear fully adequate to the task of stemming the deterioration in the country's economic and financial position. Oil revenues had recently dropped, and without any stimulus to other productive sectors of the economy, the very small base of non-oil exports would not grow rapidly. In that regard, she had been discouraged about the stagnation of the agricultural sector--even during a period of better weather--owing in large part to mismanagement of state farms and inadequate producer prices.

Some fiscal adjustment had occurred in 1985, Ms. Lundsager observed. Capital expenditures had been cut and noninterest current expenditures had apparently been held constant in nominal terms. However, those adjustments had followed several years of rather expansive hiring and spending patterns, and, while the authorities' current efforts to hold the line on expenditures were welcome, the lack of full financing of the reduced deficit appeared to signal a further increase in arrears. Hence, a reduction of government expenditures in real terms might become necessary, given the weak outlook for oil exports and fiscal revenues.

Several elements of the approach suggested in the staff report warranted reinforcement, Ms. Lundsager said. In particular, the Congo had reached the stage of external and fiscal strain that a number of its neighbors had reached a few years earlier, and the same fundamental reorientation of economic incentives that had been effected in a number of other countries was needed in the Congo. For example, education and public sector employment should be scaled back; trained labor should be encouraged instead to seek employment with the private sector. By eliminating the guarantee of employment to all graduates, the authorities would strengthen that incentive. She was encouraged to learn from Mr. Alfidja that the authorities were considering such steps.

The investment program reportedly would emphasize some small-scale private sector enterprises, Ms. Lundsager added. Such encouragement was particularly important, since a broad restructuring away from dependence on the oil sector and the parastatals was needed if the productive base of the economy was to grow and provide employment. Similarly, high priority should be given to adequate producer prices. In addition to welcoming the authorities' willingness to consider some divestiture of the numerous public enterprises and to increase the efficiency of the parastatals in general by reducing subsidies and transfers, she hoped to see broad implementation of those measures in the near future.

The alternative budgetary and external medium-term outlooks in the staff report should be helpful to the authorities, Ms. Lundsager indicated. The staff was sending them a clear signal, indicating the very serious consequences of postponement of comprehensive adjustment. With low reserves, a steady source of capital inflows would be a great help to the Congo. One such source might be the forestry sector, which should be attractive to foreign investors if a responsible overall policy stance could provide assurance that the general economic environment would permit profitability and growth.

The adjustment steps recently taken by the authorities went in the right direction, but the deteriorating external situation called for a much more comprehensive approach, which should be implemented without delay, Ms. Lundsager concluded. Finally, she endorsed the comments made by Mr. Steinberg regarding the inadequacy of the statistical base in the Congo and supported the proposed decision.

Mr. Taha noted that the Congo was facing serious economic and financial problems: real growth had been negative in 1985, public finances were weak, large external deficits had emerged, external reserves had been depleted, and arrears had accumulated. Those problems could be traced in part to factors beyond the authorities' control, but they were also due to expansionary domestic financial policies. In view of the uncertainties of the oil market, the outlook for the Congolese economy was not encouraging. The authorities had begun to realize the importance of arresting the deterioration in the economy and improving prospects over the medium term, but in order to do so, they would need to implement far-reaching and comprehensive adjustment measures of the sort outlined in the staff report.

To improve the prospects for growth in the Congo, the authorities needed to accelerate their intended reorientation of investment policy in favor of non-oil activities, Mr. Taha recommended. The cornerstone of their strategy should be the rehabilitation of the public enterprises. It was important for the authorities to improve the profitability of those enterprises by establishing pricing policies that reflected costs, tightening control of expenditures, and improving management. Technical and financial assistance from the World Bank should be helpful in those areas.

The authorities' intention to reduce the budget deficit over the next two years was appropriate, Mr. Taha added. A tight fiscal policy stance was necessary to strengthen public finances, generate domestic savings, and reduce demand pressures on the balance of payments. He welcomed the authorities' intention to freeze wages and salaries and reduce current expenditures, including transfers to public enterprises. As capital outlays had been cut every year since 1982, the authorities needed to review carefully any further cuts in the light of their policy of enhancing nonoil sector activities. He also commended the authorities' moves to diversify non-oil receipts through tax reform and improved tax administration. It would be helpful if the staff could comment on whether the authorities had a timetable for implementing their revenue and expenditure measures.

On the monetary side, it was important for the authorities to maintain a restrictive credit policy, the effective execution of which required strict financial discipline, Mr. Taha stated. The Government therefore needed to reduce its dependence on bank financing of its operations.

If the authorities' current policies continued, the balance of payments would come under increasing pressure over the medium term, Mr. Taha noted; that would be untenable, and the policies should therefore be corrected without delay. Given the high debt service ratio, the low level of reserves, and rising external arrears, the authorities should strengthen the balance of payments by implementing the firm adjustment policies that had been advocated by the staff. The authorities had already taken some important steps in the right direction, particularly on fiscal policy, and their firm stance on public sector wages and employment was commendable. However, more needed to be done, both to put the public enterprises on a sound footing and also to expand non-oil sector activities to generate sustainable growth over the medium term. The authorities' adjustment effort seemed to fall short of what was needed to tackle the Congo's problems effectively. Perhaps the staff could comment on whether the authorities had considered or were considering a more comprehensive adjustment program to be supported by Fund resources, an approach that in his view had merit.

Mr. de Forges observed that the difficulties currently facing the Congo--their causes, trends, and policies being adopted to deal with them--were strikingly similar to those reported at the time of the 1984

Article IV consultation. To compensate for problems relating to the decline in the Congo's oil receipts, the authorities had continued to implement well-oriented measures such as the curtailment of public investment, the reduction in current government expenditures, and the decrease in subsidies for inefficient public enterprises. However, while the adjustment efforts were commendable, they were insufficient to resolve the country's problems. In 1984, it had not been possible to fully finance the overall budgetary deficit, which had led to the accumulation of external arrears. The larger operating deficits of the public enterprises had also led to substantial payments arrears, despite heavy recourse to domestic bank borrowing. The overall balance of payments deficit had widened to SDR 91 million, and by the end of 1984, the external public debt had risen to approximately SDR 1.4 billion, with the total debt service ratio reaching 46 percent.

Moreover, the medium-term outlook was not optimistic, Mr. de Forges continued. The overall balance of payments deficit was projected to reach SDR 214 million by 1986, and the budgetary deficit would total SDR 150 million. Those deficits might turn out to be even larger, given the recent fluctuation of the U.S. dollar and its negative impact on the value of oil exports. Perhaps the staff could supply the Board with the most recent available data in that respect.

Because external financing would be inadequate to meet such a financing need, the Congolese authorities should commit themselves immediately to a more comprehensive and effective adjustment program, Mr. de Forges considered. The measures would have to include appropriate investment and pricing policies, rehabilitation of the public enterprise sector, reduction of the budgetary deficit, a restrictive credit policy and prudent debt management. If a program such as the one outlined in the staff report were to be implemented, viable balance of payments and budgetary positions could be achieved by 1989, although, the Congo would still face a resource gap in 1985-87, which would require international assistance, including debt rescheduling.

After some delay, the Congolese authorities and the World Bank had finally agreed on a project for reform in the water supply sector that was at an advanced stage of preparation and should be negotiated in 1985, Mr. de Forges went on. The project demonstrated the commitment of the authorities to tackle the problems affecting public enterprises and was a first step toward structural reform in the parastatal sector.

In the light of the staff's medium-term scenario and the continued deterioration of the Congo's economic and financial situation, Mr. de Forges said that he hoped that the Congolese authorities would realize the insufficiency of previous measures and move more quickly toward adopting a comprehensive adjustment program that could be supported by the Fund. They had no time to waste on half measures.

The staff representative from the African Department said that the authorities had decided to implement an adjustment program in mid-1985 aimed at financial viability and sustainable economic growth over a three- to four-year period. The staff had agreed with the authorities' diagnosis of the problem and with their stated objectives but had felt that the proposed measures were not sufficient to achieve those objectives. The authorities had announced a revised budget for 1985, as well as specific measures, including a cut of 30 percent in expenditure on material, the deferment of employment of some 3,000 persons until the latter part of the year, encouragement of early retirement of about 500 persons, and containment of the investment program. The authorities had also indicated that after they had completed certain studies, they would announce specific new measures that would be reflected in the 1986 budget. They had expressed a desire to design their own adjustment program, on which both the World Bank and the Fund staffs would be invited to comment.

The World Bank had indicated that a mission would soon be going to the Congo, the staff representative reported. A policy agreement, relating to the assistance the World Bank would be providing to help the authorities rehabilitate the public enterprises and develop the agricultural sector, would be signed. The first project to receive financial assistance from the World Bank would be the water supply company.

The authorities had been trying to improve the statistical data base in the Congo--which suffered from several deficiencies--and toward that end, they had obtained technical assistance from the World Bank in external debt and public finance, the staff representative from the African Department indicated. The authorities were also planning to request technical assistance from the Fund in the tax field.

Mr. Alfidja pointed out that there was no disagreement between the staff of the Fund and the Congolese authorities as to the assessment of the Congo's situation, although opinions diverged about the adequacy of the authorities' adjustment program. Discussions were continuing between the authorities and the Fund and World Bank staffs, which should lead to a better understanding about the course of action to be taken in 1985 and beyond in the Congo.

The Congolese authorities had made substantial efforts to improve the statistical data base, Mr. Alfidja noted; at the Annual Meetings in Seoul, they had discussed with the Fund staff the possibility of obtaining technical assistance. He hoped that if a request for such assistance were tendered, it would be favorably considered by both institutions.

The Chairman made the following summing up:

> Executive Directors were in broad agreement with the views expressed in the staff appraisal in the report for the 1985 Article IV consultation with the People's Republic of the Congo. They noted with concern that since the last consultation, the economic and financial situation of the Congo had continued to

deteriorate, not only on account of a shortfall in resources stemming from the oil sector but also because of the inadequate policy response to the country's more difficult circumstances. In 1985 oil output was expected to fall and real GDP to decline. Domestic and external imbalances had persisted; the performance of the public enterprise sector had continued to deteriorate; domestic and external payments arrears had continued to accumulate; and external reserves were virtually exhausted. Furthermore, the medium-term outlook was not favorable, especially in view of the likely stagnation of oil export receipts and rapidly rising external debt service obligations.

Directors welcomed the authorities' decision to adopt an adjustment program covering the period from mid-1985 to 1987, with a view to achieving viable balance of payments and budgetary positions and restoring sustainable economic growth over the medium term. However, Directors stressed that in order to come to grips with the country's serious problems and to achieve the authorities' stated objectives, stronger and more comprehensive adjustment measures were needed without delay. In particular, they emphasized that the necessary containment of the growth of current budgetary spending would require a reduction in the number of public sector employees, a readjustment in education policy, and a thorough overhaul of the public enterprises. A tight fiscal policy would have to be accompanied by more effective credit controls, as well as an active interest rate policy.

Directors welcomed the intention of the authorities to rehabilitate public enterprises, with the assistance of the World Bank, and they encouraged the authorities to undertake without delay the requisite measures, including personnel reductions, flexible pricing policies that reflected costs, and greater efficiency of management. Directors underscored the urgent need to limit the investment program to levels consistent with the availability of resources and to reorient it more toward the directly productive sectors of the economy, accompanied of necessity by appropriate pricing policies, as well as by measures to encourage private sector investment and production. Directors shared the view of the authorities that increasing emphasis should be placed on diversifying production, exports, and the sources of tax revenue. The renewed attention being given to stimulating agricultural production and small- and medium-scale enterprises was viewed as encouraging.

Directors called for great restraint in the contracting of external debt and encouraged the authorities to adopt policies designed to eliminate existing arrears and to avoid new ones.

Directors also urged the authorities to give priority to the necessary improvement of economic and financial statistics, a task for which the Fund could, upon request, extend technical assistance.

It is expected that the next Article IV consultation with the People's Republic of the Congo will be held on the standard 12-month cycle.

The Executive Board then took the following decision:

Decision concluding Article XIV consultation

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

2. The Fund notes with satisfaction that the People's Republic of the Congo continues to maintain an exchange system which is free of restrictions on payments and transfers for current international transactions.

Decision No. 8121-(85/160), adopted
November 4, 1985

2. VANUATU - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Vanuatu (SM/85/278, 10/7/85; and Cor. 1, 10/31/85). They also had before them a report on recent economic developments in Vanuatu (SM/85/269, 10/18/85).

Mr. Rye made the following statement:

My authorities consider that the staff mission has produced a balanced and constructive report that sets out fairly the current situation and future prospects of Vanuatu. Their few minor reservations are brought out below.

Before turning to those points, I should recall that this is only the third Article IV consultation since Vanuatu joined the Fund in 1981, after achieving independence in 1980. The country has many problems in common with other small island States, including relative poverty, susceptibility to natural disasters, and an extreme shortage of qualified administrators and technicians. As explained in the staff report, some of the legacies of the Condominium era pose additional problems.

In the face of these difficulties, the economy has performed relatively well. The rate of inflation has remained very low--in single figures since 1981, and under 2 percent in the year to June 1985. In 1984, real GDP is estimated to have risen by 5 percent following rises of 2 percent in both 1981 and 1982 and about 3 percent in 1983.

Prospects for 1985 were unfortunately dimmed by two severe cyclones that hit much of the country in mid-January 1985. There may be a fall of about 3 percent in real GDP in 1985.

Production of copra--which makes up about 80 percent of export--fell by 11.3 percent in the first half of 1985, compared with a year earlier. With the slump in world prices, the export value for copra fell over the same period by nearly 30 percent, and exports as a whole, by 22.6 percent.

Tourist numbers have continued to fall through September 1985. For those nine months, the decline was 31.4 percent over the same period of 1984. But cruise ship arrivals were well up in the seven months to July.

Despite all this, my authorities now believe that the overall balance of payments picture for 1985 as a whole is rather less gloomy than painted by the staff report--that is, they believe that the current account deficit will be somewhat lower than the SDR 5.4 million and the overall surplus higher than the SDR 5.6 million predicted by the staff. This partly reflects a lesser fall in production of copra--perhaps 15-20 percent--than originally estimated--20-25 percent.

At end-August, aggregate foreign exchange reserves were up 39 percent on a year earlier, in vatu terms. Nonetheless, my authorities accept that the economic outlook for Vanuatu has become much less favorable and that their policies, including budgetary policies, must be adapted accordingly.

Partly in response to the mission's comments, the authorities have reduced copra prices to producers by more than originally envisaged.

The Central Bank keeps a close watch on exchange rate movements and the principle of a flexible system is endorsed.

Budgetary restraints are being enforced, and every effort is being made to compress expenses. The budget for 1986 is still under discussion; this is proving a particularly difficult exercise in weighing up the strong wish to maintain a balanced budget policy against heavy pressures for expenditure increases.

The staff report comments that there is heavy dependence on aid to support government expenditure. In that regard, my authorities wish to point out that budgetary aid accounted for 13.4 percent of recurrent expenditure in 1984 and provisionally only 8.8 percent in 1985. Those figures represent considerable reductions over previous years. As to the rise in the public sector wage-bill, about 75 percent of the increase in 1984 is accounted for by replacement of funded expatriate staff by local staff.

The question of land tenure, which is highlighted in the staff report, raises difficult social issues that cannot be resolved overnight. Reform is being pressed ahead, but the pace of implementation is slower than had been hoped. As an encouragement to investors, residency permits are now being issued for expatriate employees for three years and longer instead of being subject to annual review.

On the report's reference to a weak statistical base, my authorities point out that very substantial efforts have been made in this field over the past few years and that improvements are still being made. In their view, the base should no longer be considered weak.

Mr. Leonard observed that Vanuatu shared a number of difficult problems with other small island economies. Because Vanuatu was also struggling with the implications and complications of independence, the authorities had cause for much satisfaction in the economic progress achieved since the country's independence in 1980. Growth had been satisfactory, and the rate of inflation had been moderate. The overall balance of payments had been in surplus, reserves had accumulated, and external debt was virtually nonexistent. Even more significantly, the authorities had shown prudence and firmness in their fiscal policies and the government finances had been kept in approximate balance.

What had been done had been done well, and there was not much ground for qualifying comment, based on the staff report for the Article IV consultation, which focused normally on the cyclical and the short term, Mr. Leonard continued. However, the adequacy of what Vanuatu had done needed to be examined in the light of the Government's longer-term objectives. Financial self-reliance in the fiscal and external areas was one of those goals, as well as balanced regional and rural growth, the development of human resources through educational, technical, and social programs, the buildup of the Ni-Vanuatu private sector, and minimization of social disruption through the preservation of the customs and culture of the people.

The staff report had not only discussed the fiscal and external patterns as the accounts showed them but had also provided a useful perspective on financial self-reliance, Mr. Leonard stated. The data portrayed what the trends would have looked like in the absence of the considerable external support that the authorities were currently receiving, mainly from the United Kingdom and France, but also from several other countries. The adjusted trends showed a steady reduction in the current budget deficit from 1981 onward until 1985 when as a result of unfavorable economic conditions, the deficit had risen both absolutely and as a percentage of GNP. Therefore, provided that the weakening in the current budget could be rectified, the authorities would probably be able to reach their subgoal of dispensing with external support for current budgetary purposes no later than 1988. The overall budget continued to depend--to the extent of about 50 percent--on foreign grants, however. In order to reduce the massive dependence on external aid, which inevitably would taper off over time, the authorities needed to aim at sizable current surpluses while making provision for increased development expenditures and any debt service that would arise as a result of foreign borrowing.

Thus he, like the staff, advocated fiscal restraint both for the short and the longer term, Mr. Leonard said. Expenditure would not only have to be kept on a tight rein but might also have to be reordered in favor of education to meet Vanuatu's manpower training and social needs and developmental spending. Indeed, as education spread and improved and more of the population moved into the monetized sector, the challenge to economic managers to meet the aspirations of the people for their employment and living standards would also intensify, as would pressures on spending. In maintaining fiscal balance in that prospective situation, the authorities would have to watch public sector wages carefully to avoid giving the wrong signal to the private sector and to avert the danger of unacceptable disparities in living standards emerging among different groups in the islands, with the consequent social tensions.

A broadening of the revenue base was an obvious necessity in the face of Vanuatu's present reliance on import duties, Mr. Leonard indicated. A sales tax, which would yield increased revenues as the economy grew, was worthy of examination in the context of a general examination of revenue possibilities.

The central issue facing the economy was one of development rather than adjustment, Mr. Leonard considered. Of foremost concern was the country's overdependence on exports of a single commodity--namely copra, which left the economy subject to the vagaries of weather and the global markets for copra and needed to be remedied by diversification of the productive base. The brightest prospects for diversification appeared to be in the areas of agricultural exports and tourism. It was regrettable that the complications associated with the land tenure system had not yet been sorted out. During the discussion of the 1984 Article IV consultation (EBM/84/100, 6/27/84), the Executive Directors had recognized that a streamlining of the system was urgently required to restore the confidence of potential foreign investors in the agricultural sector, yet little progress seemed to have been made over the past year, and some of the authorities' efforts had appeared to stall. The authorities should take the necessary hard decisions and resolve the impasse that was inhibiting agricultural development.

Production and export diversification, which provided the counterpart means on the external side of the financial self-reliance that the Government was seeking in its own fiscal affairs, could only become more urgent with the passage of time, Mr. Leonard mentioned. The Government had been implementing several useful measures to promote investor confidence in Vanuatu. While those measures could be expected to yield results in due course in the form of growth and a more balanced economy, more rapid progress in those directions still depended largely on land tenure reform.

The authorities had rightly decided to adopt an exchange rate policy that would instill confidence in the currency, Mr. Leonard commented. The SDR peg seemed to have brought about that confidence, although the two revaluations in the past year and a half might have caused some misgivings. The vatu had recently appreciated sharply against the Australian dollar, which gave rise to the general question of whether the SDR represented an appropriate basket against which the vatu was to be pegged. Table 15 of the report on recent economic developments, showing the direction of domestic trade, indicated that an alternative weighted basket, which would reflect more closely Vanuatu's trading linkages, might be used. Perhaps Mr. Rye or the staff might comment on that possibility.

The Government was undertaking a Second National Development Plan and in cooperation with the World Bank, it intended to hold an Aid Donors' Conference in mid-1986 to discuss the Plan, Mr. Leonard noted with pleasure. He hoped that the Fund staff would keep in close touch with the evolution of the Plan and would participate in the Conference.

Mr. King commended the authorities for their maintenance of sound economic policies despite the difficult circumstances they had faced in 1985, including the cyclones that had affected much of the country in January and the falls in the price of copra on the world market. The devaluation in April and the measures taken in May to reduce the projected fiscal overshoot had been appropriate responses to those problems. From a longer-term perspective, the achievement of a sustainable fiscal position had been a significant success, given the fall in the proportion of recurrent expenditures financed by grants from 50 percent in 1980 to less than 10 percent in 1985. The authorities were to be congratulated for the important progress they had made in the five years since independence in laying the basis for sustained development.

Given the decline in the proportion of expenditure financed by grants, the fiscal position was likely to remain difficult over the coming years, Mr. King suggested. The prospects for significant revenue-raising measures were not good in view of the weak outlook for copra prices and the difficulty in achieving strong revenue expansion, particularly as the authorities believed an income tax would be inappropriate at the current stage of development. Perhaps the staff might comment on the scale and nature of the difficulties that an income tax would present. The weak revenue position of Vanuatu emphasized the need for continued expenditure restraint and increased efficiency of existing expenditure programs. In that connection, he had noted with concern the 13 percent rise in the public sector wage bill in 1984 while consumer prices had risen by only just over 5 percent; however, as Mr. Rye had indicated, that largely represented the costs of replacing funded expatriate staff with local staff. The hiring freezes in the public sector that had been imposed during part of 1984 and 1985 appeared to be, at best, a temporary expedient in the face of the rising wage bill. He would be interested to learn from Mr. Rye or the staff whether any more radical measures were under consideration.

He supported the staff's emphasis on the need to buildup the capabilities of the Central Bank to allow it to respond more flexibly to future developments, Mr. King commented. He was pleased that the Central Bank hoped to assume the roles of banker to the Central Government and manager of the foreign exchange reserves before the end of the coming year. However, the shortages of skilled manpower underlined the need to avoid overrapid expansion. It was essential for the Central Bank to master fully its existing functions before it undertook new roles.

Despite the devaluation earlier in 1985, the real exchange rate had remained some 10 percent higher than the average level prevailing from independence until early 1984, Mr. King said. He supported the staff's emphasis on the appropriateness of greater exchange rate flexibility, even though the authorities held the view that Vanuatu was competitive with nearby tourist destinations. Such exchange rate flexibility was particularly important in the light of Vanuatu's continuing dependence on copra exports and its need to broaden the export base.

The relatively large areas of land currently under dispute following the change in the legal arrangements for land titles represented a significant lost investment opportunity, a situation that was an obvious source of concern, Mr. King remarked. The backlog of cases waiting to go before the Supreme Court was regrettable, and he asked the staff to indicate whether it expected any imminent progress in clearing it up.

The authorities had followed prudent policies in the face of difficult circumstances in 1985, Mr. King concluded. The rapid rate of population growth and the likelihood of some continuing fall in aid receipts over the next few years underlined the need to maintain and, where appropriate, extend those policies.

Mrs. Walker observed that after having achieved a positive economic performance since independence, Vanuatu had unfortunately faced some difficult external circumstances in early 1985, which had resulted in a much less favorable outlook for the year than originally projected. However, the authorities had responded quickly to the cyclones and the decline in copra prices by adopting an austerity budget and devaluing the vatu vis-à-vis the SDR. The Government's actions, along with a quick recovery in some of the problem areas and slightly better copra production than expected, had helped to curb the anticipated weakness in the overall balance of payments picture for 1985, according to Mr. Rye, whereas the current account outlook remained difficult. The staff had projected a weak medium-term balance of payments outlook for Vanuatu's economy, and the authorities had to adopt development policies with that in mind, taking into account Vanuatu's external vulnerabilities.

The authorities recognized the need for continued budgetary restraint, Mrs. Walker commented, and she welcomed their actions to keep recurrent spending within the budget. In view of the limited sources of future revenue and the projected decline in external grants, however, the authorities would need to continue their prudence in spending, particularly in the area of wages; they also needed to increase government efficiency.

Foreign investment in Vanuatu remained weak for a number of reasons, most notably because of uncertainties over land tenureship, Mrs. Walker noted. While she understood the difficulties involved with solving the problems associated with land tenureship, she urged the authorities to continue to move toward a reasonable solution of the issue in the near term in order to limit the damaging effect that the failure to resolve it was having on the economy, particularly in discouraging badly needed foreign investment in certain export sectors. The authorities had taken steps to facilitate the extension of work permits for expatriate managers and to formulate an investment law to help clarify conditions for investment, but it was clear that new investments depended on an early resolution of the land tenure issue.

Tourism clearly was a major source of foreign exchange earnings for Vanuatu and was in need of further development, Mrs. Walker indicated. While external factors probably had discouraged tourists from visiting Vanuatu recently, it appeared that the depreciation of the Australian dollar vis-à-vis the vatu had also contributed to the decline in tourist trade. Although the vatu was still above its early-1984 level, the welcome devaluation of April 1985 should help reverse the situation. She encouraged the authorities to maintain a flexible exchange rate and to enact their plan to promote tourism.

The staff's medium-term balance of payments scenario pointed to the need for expansion and diversification of the export base, Mrs. Walker concluded. The reduction in the procurement price for copra was welcome but the authorities needed to be careful to conserve the stabilization fund resources without setting the price so low as to discourage production. A flexible exchange rate policy, elimination of some of the institutional obstacles to development, favorable support from the donor community for the forthcoming development plan, and assistance from the World Bank should assist Vanuatu in achieving a more favorable growth and balance of payments position in the medium term.

Mr. Murakami remarked that in spite of structural weaknesses such as high transportation costs, weak infrastructure, a lack of trained manpower, and unique land tenure problems, the economy of Vanuatu had performed well for the first five years since the country's independence. Real growth had been satisfactory with a moderate rate of inflation. Both the current and overall balance of payments had been in surplus.

The authorities had followed a highly commendable, prudent economic management approach, characterized by fiscal policy aimed toward balancing the recurrent budget.

However, Vanuatu faced some difficult medium-term economic problems, Mr. Murakami observed. Although the problems had been pointed out on the occasion of the preceding Article IV consultation with Vanuatu, they seemed to have become more imminent in 1985. The first current account deficit since independence was expected to emerge in 1985. The staff's medium-term projections indicated a steady and fairly rapid increase in the current account deficit through 1990. In spite of declining foreign grants in support of the recurrent budget, considerable pressures existed for a sharp expansion in expenditures for the coming years. He welcomed the decisive policy actions taken by the authorities during the course of 1985, which included the devaluation of the vatu in April and the adoption of an "austerity budget" in May. Nevertheless, more corrective action was necessary to address the medium-term problems.

As total government expenditure amounted to about one half of GDP, the size of the public sector, according to the staff report, "exceeds the country's ability to support it," Mr. Murakami stated. Indeed, the unification and simplification of the condominium and the English and French educational systems, and the improvement in manpower in the public sector could be dealt with only in a medium- to long-term context. Perhaps the World Bank's role was more important in those areas. However, it was clear that continued restraint in fiscal policy would be necessary. Hence the improvement in the salary and wage structure of the public sector, which was currently under way, should be completed as quickly as possible. The authorities had made commendable efforts to raise domestic revenues, based on the collection of import duties. However, those efforts seemed to have reached their limit, and the authorities therefore should give due consideration to the introduction of new revenue-raising measures--for example, some form of income tax or sales taxes in order to secure the necessary strong revenue expansion for the future. Although the recent reduction of the copra procurement price was welcome, further adjustment would be necessary to reduce the remaining substantial subsidy element in the price.

In order to promote exports and tourism, it was essential for the authorities to maintain a flexible exchange rate policy, Mr. Murakami considered. Although the devaluation of the vatu in April had been a policy action in the right direction, the effective exchange rate of the vatu was still about 10 percent higher than it had been prior to the revaluation in early 1984; moreover, the vatu had recently appreciated sharply against the Australian dollar, reflecting the decline in the value of the Australian dollar vis-à-vis the SDR. Therefore, the authorities should watch Vanuatu's competitive position closely and, if necessary, exercise greater flexibility in exchange rate policy. While he did not intend to challenge the appropriateness of the revaluation of the vatu in March 1984, he had noted the statement on page 24 of the report on recent economic developments that the revaluation had not offset inflation commensurately because the local merchants had been unwilling to reduce their prices on imported goods.

Since its establishment, the Central Bank of Vanuatu had made considerable progress in developing its economic monitoring and policy functions, Mr. Murakami noted. In view of the openness of the economy and the existence of an offshore market, however, implementation of an appropriate and effective monetary policy was a challenging task, which would require skilled manpower as well as effective policy instruments. At the same time, however, the authorities should not neglect fiscal policy, which played a crucial role in Vanuatu's economy.

The staff representative from the Asian Department said that the authorities did monitor an effective exchange rate based on trade weights. Experiments with the composition of the currency basket and attempts to update it had demonstrated that it was relatively insensitive to rate changes in weights and that the broad picture obtained in terms of movements in the real effective exchange rate was very similar irrespective of the composition. The peg to the SDR was very popular, particularly with the private sector, which considered that the peg gave strength to the currency. The real effective exchange rate was monitored by the authorities, but a change to a new exchange rate system might not be well understood by the public.

It was possible to design an income tax that could take care of Vanuatu's unique situation as a tax haven, as had been discussed extensively a few years earlier in a Fund technical assistance report, the staff representative remarked. However, the authorities did not believe that they had sufficient staff to monitor such a complex income tax system, which was an important consideration. Moreover, a substantial part of the tax base would be the incomes of the expatriate technical assistance experts funded by grants from various governments, which might cause some complications.

To control the public sector wage bill, the authorities were engaged in two aspects of civil service reform, the staff representative noted. A government-wide job evaluation exercise had been conducted and a new salary structure was being introduced. The wages of about 35 percent of the general service, professional, and managerial staff of the Government had been frozen at their current levels. Moreover, the steps in each grade had been revised and were much smaller and more uniform.

No further information was available concerning the speed with which the Supreme Court might clear the land reform cases, the staff representative from the Asian Department concluded. The Supreme Court had to decide the cases according to custom; none of them had been decided yet.

Mr. Rye pointed out that of the countries in his constituency, Vanuatu faced the most drastic shortages of skilled administrators and policy advisors, and some of the Directors' comments needed to be seen in that light. Mr. King had made a very valid point about the need for the Central Bank to guard against overrapid expansion of its role, given the extreme shortage of people who could effectively assume such responsibility. Similarly, there was a shortage of people who could administer a tax system, however well designed. Such severe personnel limitations had an impact on Vanuatu's ability to achieve the desired progress in some directions.

Considerable debate was under way in government circles about the next year's budget, Mr. Rye mentioned. The Minister of Finance was arguing very strongly for retention of the balanced budget philosophy, which Vanuatu had pursued thus far; he was standing firm in the face of very strong pressures for increases in various outlays, many of which would be quite warranted if they were viewed in isolation. However, such outlays might not be wise for Vanuatu in the long run and the Minister of Finance was thus very keen to ensure that fiscal restraint played its proper role in combating Vanuatu's long-term problems. The outcome of the debate was as yet unclear.

For the moment, the Government had done about as much as could be expected in terms of systemic land reform, Mr. Rye concluded. It was a sensitive matter in a traditionally oriented society such as Vanuatu. As the staff representative from the Asian Department had pointed out, the decisions would have to be made by the Supreme Court. He agreed with those who would like to see progress in resolving the problem as soon as possible, because the current uncertainty clouded the investment and other prospects of Vanuatu. The authorities shared that view, but there were limits to how rapidly progress could be achieved.

The Chairman made the following summing up:

> Executive Directors expressed agreement with the thrust of the staff appraisal in the report for the 1985 Article IV consultation, and commended the Vanuatu authorities for their prudent economic policies and the considerable progress achieved since independence. In spite of the structural constraints that Vanuatu shared with other small island economies, economic activity had expanded at an encouraging pace and had been accompanied by relative price stability, maintenance of an overall balance of payments surplus, a buildup in external reserves, and a low level of external debt. Continuation of sound financial policies, especially budgetary discipline, would provide the needed framework within which to pursue the development goals of the forthcoming Five-Year Plan.
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> Directors took note of the recent decline in Vanuatu's tourist arrivals, the fall in the world copra price, and the damage caused by the cyclones in January 1985, as a result of which real GDP was expected to fall by about 3 percent in 1985. Since the authorities were expecting a smaller fall in copra production than previously forecast, they estimated a somewhat

better balance of payments outcome than that projected by the staff. Nevertheless, the deterioration in the balance of payments position in 1985 was sharp and developments would need to be carefully watched. Directors commended the recent decision to adjust the copra procurement price in order to maintain remunerative producer prices over a longer period and to moderate demand pressures. Further, Directors welcomed the adjustment of the exchange rate earlier in the year and attached importance to the authorities' intention to maintain a flexible exchange rate policy. They noted nonetheless the gradual appreciation in real effective terms of the exchange rate over recent years.

Directors observed that substantial progress had been achieved in attaining greater self-reliance in the recurrent budget. Budgetary grants had fallen from the equivalent of half of recurrent expenditures in 1980 to only 9 percent in 1985. Given the adverse circumstances facing the Government at the beginning of the year, Directors commended the authorities for their decisive action in revising the budget to achieve a fiscal outturn for 1985 that contributed to stabilizing the economy. Directors expressed concern, however, over recent mounting pressures to expand recurrent expenditure, and urged the authorities to follow a policy of restraint in the formulation of the 1986 budget. Continued adjustment efforts would be required in the period ahead, as grants currently financed nearly all development expenditure and large amounts of technical assistance. Directors stressed that the fiscal adjustment effort must continue to focus on economy in the hiring and salaries of civil servants and on improved efficiency in the provision of government services. While the domestic tax effort had been considerable, further actions to broaden the tax base would also be required, and it was suggested that the introduction of a sales tax, or perhaps an income tax, be considered. The size of the Government relative to the economy was considered large.

Directors observed that Vanatu needed to diversify and expand its exports to strengthen the balance of payments and the productive base of the economy. Accordingly, the authorities were commended for their decisions to adopt an investment law and to liberalize the issuance of residence permits. Higher levels of investment would allow Vanuatu better to realize its full economic potential and would facilitate attainment of its development objectives. Speakers recognized the complexity of the issues relating to rural land leases and their crucial bearing on the further development of Vanuatu; progress in their resolution would therefore require continued determination on the part of the Government.

The plans for the Central Bank of Vanuatu to act as the Government's depository and manage foreign exchange reserves were welcomed. Directors stressed the need to develop instruments to control the expansion of domestic credit. It was pointed out that progress had been made in establishing a sound statistical base, especially in the areas of balance of payments and financial statistics.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/85/159 (11/1/85) and EBM/85/160 (11/4/85).

3. RELATIONS WITH GATT - CONSULTATIONS WITH THE CONTRACTING PARTIES - FUND REPRESENTATION

The Executive Board approves Fund representation at the consultations with the CONTRACTING PARTIES to the GATT to be held in Geneva from December 2 to December 13, 1985 as set forth in EBD/85/278 (10/28/85).

Adopted November 1, 1985

4. EXECUTIVE BOARD COMMITTEES - NOMINATION

The Executive Board approves the nomination by the Managing Director for the vacant position on the Committee on Executive Board Administrative Matters and on the Committee on Interpretations as set forth in EBD/85/279 (10/30/85).

Adopted November 1, 1985

5. APPROVAL OF MINUTES

The minutes of Executive Board Meeting 85/19 are approved. (EBD/85/277, 10/28/85)

Adopted November 1, 1985

6. EXECUTIVE BOARD TRAVEL

Travel by an Advisor to Executive Director as set forth in EBAP/85/264 (10/31/85) is approved.

7. STAFF TRAVEL

Travel by the Managing Director as set forth in EBAP/85/265 (11/1/85) is approved.

APPROVED: June 12, 1986

LEO VAN HOUTVEN
Secretary