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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/185

3:00 p.m., December 20, 1985

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	A. R. Ismael, Temporary
	E. L. Walker, Temporary
	S. Kolb, Temporary
	G. Nguyen, Temporary
	M. Z. M. Qureshi, Temporary
H. Fujino	
	A. Bertuch-Samuels, Temporary
Huang F.	
J. E. Ismael	Jaafar A.
	J. R. N. Almeida, Temporary
	R. Fox, Temporary
	S. Simonsen, Temporary
	G. W. K. Pickering, Temporary
	W. K. Parmena, Temporary
	M. A. Weitz, Temporary
	L. P. Ebrill, Temporary
	J. de la Herrân, Temporary
	J. de Beaufort Wijnholds
	A. V. Romuâldez
	R. Msadek, Temporary
	S. Govindarajan, Temporary
	L. Tornetta, Temporary

J. W. Lang, Jr., Acting Secretary
K. S. Friedman, Assistant

Also Present

IBRD: W. Struben, East Asia and Pacific Regional Office. Asian Department: P. R. Narvekar, Deputy Director; I. Otani, S. Shah. Exchange and Trade Relations Department: E. H. Brau. External Relations Department: G. P. Newman. Fiscal Affairs Department: G. M. Bartoli. Legal Department: W. E. Holder. Bureau of Statistics: E.-G. Lim. Advisors to Executive Directors: S. Ganjarerndee, H.-S. Lee. Assistants to Executive Directors: Z. b. Ismail, H. Kobayashi, J. Reddy.

1. FIJI - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Fiji (SM/85/309, 11/18/85). They also had before them a staff report on recent economic developments in Fiji (SM/85/312, 11/29/85).

Mr. Ismael made the following statement:

> My authorities in Fiji are in broad agreement with the staff analysis and appraisal of the developments and prospects for the Fiji economy. My authorities share many of the concerns expressed in the staff paper; and indeed, in the 1986 budget announced in early November 1985, they have already taken a number of measures to further stabilize the economy. Latest data received from Fiji indicate that real GDP in 1985 will decline by 2.2 percent, due to a sharper reduction in sugar production than what was envisaged at the time of the mission. Fiscal deficit is also somewhat larger than what was indicated at the time of the mission. The balance of payments surplus in 1985 is now expected to be F$20 million--SDR 17 million--as compared to a surplus of F$12 million--SDR 10 million--in the staff report. These changes, however, do not affect the validity of the staff conclusions.
>
> The performance of the Fiji economy in 1985 can be characterized as mixed. Severe cyclones in January led to a 29 percent reduction in sugar production and to lower tourists arrivals. Consequently, real GDP declined by over 2 percent. At the same time, the inflation rate declined to 4.4 percent in 1985 as compared to 5.4 percent in 1984; and the overall balance of payments is expected to show a surplus of over F$20 million--SDR 17 million--reflecting mainly the positive effects of adjustment measures introduced by the Government as well as a substantial inflow of insurance payments from abroad following the January cyclones. Fiji's external reserves, now equivalent to 4 1/2 months of imports, are considered to be at a comfortable level.
>
> The prospects for Fiji's economy in 1986 are much better. Real GDP is expected to grow by more than 4 percent, with sugar production increasing to 420,000 tons in 1986 as compared to 340,000 tons in 1985. Tourist arrivals are expected to show a strong growth of over 10 percent. Investment activity is also expected to show a strong recovery, reflecting sharp increases in the hotel construction activity and in the wood processing industry. In the 1986 budget, the Government's own investment plan for 1986 is also expanded, so that the pace of economic growth and diversification could be accelerated. Growing unemployment continues to be a matter of concern to my authorities. It is expected that the recovery in investment

activities in 1986, together with the Government sponsored vocational training programs to be introduced in 1986, will help alleviate the problem. The rate of inflation in 1986 is expected to accelerate somewhat to 5 percent, due mainly to the impact of Government's policy to shift the burden of taxation from direct to indirect taxation. The overall balance of payments is expected to show a small deficit.

The efforts of my authorities in the area of fiscal adjustment has been most remarkable. The central government deficit was reduced from 6.6 percent of GDP in 1982 to 4.0 percent in 1985. As a result of the tax measures introduced in the 1986 budget and the decision to freeze the recruitment, as well as the merit increments and cost of living adjustments for civil servants, it is now expected that the budget deficit in 1986 will be reduced to 3 percent of GDP. The Financial Review Committee which was established to review Government's expenditure and revenue policies has made a number of recommendations which my authorities are in the process of implementing. Recommendations to improve the efficiency in Government are being studied by the Ministry of Finance and by the Public Service Commission. A Public Enterprise Unit has been set up in the Ministry of Finance, and efforts are being made to improve its staffing. A more fundamental recommendation of the Committee was to shift the burden of taxation from direct taxes to indirect taxes. In his 1986 budget, the Minister of Finance has reduced the average individual income tax by 10 percent and has increased indirect taxes on a range of goods and services. The base for indirect taxes has been widened, turnover taxes on a wider range of services have been introduced, and certain fringe benefits provided by employers have been brought within the tax net. As a result of these measures, the budget deficit is now expected to decline to about 3 percent of GDP.

My authorities have made effective use of monetary policy instruments in controlling inflation, in improving the balance of payments, and in channeling financial resources to productive sectors of the economy. In addition to earlier measures, the authorities decided in November 1985 to take additional measures to curb monetary growth in order to promote price and external stability. The banks collectively are required to hold special deposit with the Reserve Bank in an amount of F$5 million. The liquidity situation will be monitored closely to see if any further changes are required.

Real interest rates have become highly positive in the last few years because of the low inflation rate. My authorities are faced with a dilemma in managing the interest rate policy. Interest rate on government bonds, which are put out on tender, have been declining for some time. This suggests that some easing of interest rates may be appropriate to promote investment. However, interest rates also serve as an incentive for savings which would be needed to finance the investment program under the Ninth Development Plan. In addition, real interest rates in some of the neighboring countries are very high, and there is a risk that any reduction in the rates in Fiji could lead to capital flight. Hence, my authorities believe that in the light of the circumstances now prevailing in Fiji and in the region, it may be premature to ease interest rates.

In addition to the successful stabilization efforts, the monetary authorities have made a major effort in promoting new financial institutions which would play a crucial role in the future development of Fiji. Government has approved a feasibility study undertaken by the IFC to establish a merchant bank which will initially concentrate on leasing operations before developing into a full-fledged merchant bank. My authorities will also establish a National Investment Corporation which will serve as the investment arm of both Government and the Fiji Development Bank.

Uncertainties regarding incomes policy in 1986 is a matter of grave concern to my authorities, and its evolution in the coming year will very much determine the investment and growth prospects as well as the balance of payments outlook for 1986 and 1987. My authorities have shown a lot of political will in imposing the incomes freeze in 1985 which has already brought about substantial economic gains in terms of price, fiscal, and external performance. Some of the indirect effects of the freeze on incomes, such as those on promotion of investments and employment, will only be realized if investors gain confidence that wage growth will continue to be moderate. In this context, my authorities have proposed a modified indexation formula to the trade unions. Under this proposal, the wages guideline for 1986 is to be determined by productivity growth, movements in the terms of trade, and changes in the price level. The response of trade unions to this proposal has been largely negative. Nonetheless, my authorities have announced that the present freeze on wages and salaries would be continued until a modified formula is agreed upon. This announcement brings out the importance which my authorities attach to wage stability as a means for gaining international cost competitiveness, for achieving fiscal, monetary and price stability, for conserving foreign exchange resources, and for creating new jobs.

Exchange rate stability is an important objective of my authorities. To this end, my authorities have endeavored to maintain a stable relationship between the Fiji dollar and the currency basket to which the Fiji dollar is pegged. Occasionally, discretionary adjustments are made to ensure that real effective exchange rate does not get out of line with the objectives of the exchange rate policy. The real effective exchange rate has depreciated by some 4 percent in the last two months because of a sharp depreciation of two currencies which account for a substantial weight in the currency basket. My authorities are also conducting a review of the composition and weights in the currency basket to ensure that they are consistent with their external objectives. This review is expected to be completed in the early part of 1986.

Protection granted to domestic industries has been on an ad hoc basis, and there is a clear need to rationalize it. Some industries have received excessive protection over a prolonged period of time. My authorities recognize the problem and have sought technical assistance in this area from the World Bank. It is expected that World Bank staff will make very specific recommendations which can be translated into operational decisions.

It can be said that adjustment efforts undertaken by my authorities have been highly successful. But the economic structure remains fragile. Weak investment in recent years has contributed to low growth and a rapid increase in the unemployment levels. The real challenge for my authorities now is to accelerate the pace of investment and growth without sacrificing stabilization goals achieved mainly through the prudent management of macroeconomic and incomes policies. In promoting investment, my authorities will be eager to receive any assistance that multilateral development institutions can provide. In this context, I note with regret the policy which the World Bank has adopted toward Fiji and other Pacific islands. Under this policy, the World Bank will not initiate or directly sponsor project loans in Fiji--a policy which raises questions regarding equality of treatment of Bank members. It is also a matter of regret that no new loan commitments have been made by the World Bank between January 1981-June 1985. Given my authorities' intention to keep the external debt service obligations low and their intention to avoid market borrowing as far as possible, assistance provided by multilateral development institutions will be crucial for the future development of Fiji.

The staff representative from the Asian Department said that the latest information showed that the overall 1985 budget deficit was expected to be about 4 percent of GDP, slightly larger than was estimated in the staff report, mainly because customs duties were somewhat smaller than had been expected. The overall balance of payments surplus in 1985 was expected to be about SDR 17 million. The main difference between that revised estimate and the lower estimate in the staff report was the considerably smaller errors and omissions item in the original balance of payments estimate. Moreover, the staff had estimated that the index for the nominal effective exchange rate was about 103 in October 1985, and that the index for the real effective exchange rate in October 1985 was about 99. Those levels were roughly the same as those prevailing a year earlier, when the effective exchange rates had begun to appreciate. The overall budget deficit envisaged under the 1986 budget was about 3 percent of GDP, or about a half percentage point lower than the figure in the staff report. The lower deficit was due largely to new tax measures.

Mrs. Walker remarked that Fiji's economic performance during 1985 had been affected by external factors, particularly the damage caused by cyclones. As a result, the 1985 performance was mixed. Moreover, the staff had concluded that the outlook for Fiji's economy in 1986 also was mixed: favorable external conditions and measures adopted by the authorities had improved the prospects for an increase in real GDP and a recovery in tourism; however, the unemployment situation was not expected to improve noticeably, and the external payments position was expected to deteriorate somewhat. The medium-term outlook was uncertain, particularly with respect to Fiji's ability to achieve broadly-based real economic growth averaging 5 percent per year while generating employment and reducing the external current account deficit. The staff had broadly outlined the economic measures that would help Fiji to achieve the economic objectives set out in the Ninth Development Plan. A complete package of measures, including financial, commercial, and exchange rate policies, would be needed to achieve sustainable external payments and budget positions over the medium term.

The reduction of the Federal Government deficit in 1985 was welcome, but the staff report clearly showed that a further effort to reduce the deficit was needed, Mrs. Walker said. She was pleased that the budget estimates for 1986 were more favorable than the estimates projected in the staff report. Wage restraint had clearly been a significant factor in the lower than estimated current expenditure in 1985. In general, however, wage freezes were not the most efficient means of curbing price increases. Nevertheless, the authorities were to be commended for adhering to their strict wage policy in the current circumstances. In the future, a reasonable wage policy should lessen the pressure on the budget and reduce the likelihood of having to resort to wage freezes.

She was pleased that the authorities had implemented a 10 percent tax reduction, Mrs. Walker remarked. The reduction should act as an incentive for investment and production and should not unduly exacerbate the unemployment problem, provided that a conservative wage policy was maintained and investment recovered.

She welcomed the authorities' intention to shift government expenditure to efficient projects and programs that could establish a solid foundation for generating growth and employment, Mrs. Walker continued. The World Bank's assistance in establishing priorities for the various investment projects was welcome.

The Government's involvement in promoting joint ventures with the private sector should be undertaken with caution to avoid supporting enterprises that could become a drain on government resources, Mrs. Walker commented. However, the authorities' increased efforts to promote private sector activity were welcome.

Improvement in the financial position of public sector enterprises would reduce the burden of those enterprises on the public sector budget, Mrs. Walker said. More systematic monitoring and evaluation of the public enterprises' performance would be necessary, but additional efforts must be made to increase the enterprises' efficiency, and World Bank assistance in that area would be appropriate. The authorities' intention to review the protection and incentive schemes in conjunction with the World Bank was welcome.

Fiji's external payments position remained under pressure, Mrs. Walker noted. The recent changes in the exchange rate noted by the staff representative in his opening statement were appropriate, and she hoped that the authorities would continue to maintain a flexible exchange rate based on an appropriate mix of currencies and weights that would help the authorities to meet their external objectives, particularly the projected 10 percent increase in tourist receipts in 1986. The authorities should maintain their sound economic policies in the coming period.

Mr. Ebrill remarked that the economic circumstances in Fiji were similar to those in many other developing countries. Fiji relied heavily on a single commodity, sugar, for export earnings. As a result, even though Fiji had been able to negotiate some favorable contracts for sugar exports, the country's terms of trade had deteriorated by some 32 percent since 1980. That development was particularly serious, given the openness of Fiji's economy. Fiji had also experienced inclement weather, including severe cyclones in 1983 and 1985.

While the circumstances in Fiji were typical of other developing countries, the conduct of economic policy in Fiji had been less so, as the authorities had made a serious effort to restore and maintain domestic and external equilibrium, Mr. Ebrill continued. For example, the fiscal deficit had been reduced from 6.6 percent of GDP in 1982 to 4 percent in 1985 and was expected to fall to 3 percent in 1986. At the same time, there had been a sharp drop in Fiji's external borrowing, a development that reflected the authorities' determination to avoid external debt problems. Furthermore, since the establishment of the Reserve Bank of Fiji in January 1984, a tight monetary policy had complemented the authorities' overall adjustment effort. The only apparent weakness in economic policy was in the area of wages. However, the broad remuneration freeze in 1985 had somewhat offset that weakness. On balance, the authorities were to be commended for having tailored their economic policies to actual developments. The main task facing them in the coming period was to capitalize on their adjustment effort in order to bring the economy back on to a path of sustained growth. To achieve that objective the authorities would have to maintain cautious short-run demand management policies and adopt policies aimed at achieving comprehensive long-term structural change.

The staff's medium-term scenario underscored the vulnerability of Fiji's economy, Mr. Ebrill continued. The scenario was based on the assumption that the elasticity of export volume to GDP growth was relatively low and that the elasticity of import volume to domestic demand was relatively high. Accordingly, an increase in the rate of economic growth would result in unsustainable balance of payments deficits. Those assumptions were based on recent experience. The key to avoiding the undesirable balance of payments outcome suggested by the medium-term scenario was to diversify the economic base, thereby creating new export possibilities, and some promising steps in that direction had already been taken. Tourism had become a significant industry, a development that had been beneficial not only because of the foreign exchange generated by tourism, but also because much of the development of the tourist sector had been financed by foreign direct investment rather than by foreign borrowing. In addition, the completion of the Monasavu Hydroelectric Scheme had given Fiji a margin of generating capacity that should help to sustain the positive trends in the economy.

The main changes in short-run demand management policy had occurred in the fiscal area, Mr. Ebrill noted. The authorities were in the process of implementing a major tax policy initiative involving a shift from income taxes to custom and excise taxes. The reduction of 10 percentage points in marginal income tax rates would undoubtedly improve incentives. However, Fiji was noted for the effectiveness of its income tax administration, and he had some reservation about the wisdom of tampering with a system that was obviously working well. In particular, he hoped that the level of overall administrative efficiency of the tax system would remain high. Even more important, while he was pleased that the increase in customs and excise revenue would result from an expansion of the tax base as well as from an increase in rates, he had noted that most excise tax rates were specific. He agreed with the staff that the authorities' shift to excise taxes might result in a decline in the overall elasticity of the tax system. A shift to a sales tax seemed to offer distinct advantages. Since indirect taxes were broadly based, a shift to a sales tax would not be difficult.

In his opening statement Mr. Ismael had raised the important issue of the World Bank's involvement in Fiji, Mr. Ebrill recalled. The World Bank staff representative should comment on the current and prospective relations between Fiji and the World Bank.

The authorities were to be commended for the way in which they had accommodated the conduct of their economic policy to changes in the external environment, Mr. Ebrill concluded.

Mr. Fujino noted that Fiji's economic development had been adversely affected by the deterioration in the terms of trade in 1985 and by the effects of the cyclones in recent years. However, the external balance had improved somewhat and the rate of inflation had been further reduced as a result of the tightening of monetary policy and the introduction of a wage freeze. Although the debt service ratio had increased in 1975 to 15 percent, the economy was unlikely to be destabilized significantly in the short-run, especially in light of the present relatively comfortable reserve position.

However, the medium-term economic growth prospects were not fully promising, Mr. Fujino remarked. Real GDP had grown by only 1 percent on average during the first half of the 1980s, significantly below the rate of population growth. The authorities were worried about the recent rise in the rate of unemployment, and they were considering setting a 5 percent economic growth target under the Ninth Development Plan, which was to be implemented starting in 1986. The achievement of such an ambitious growth target in a small open economy like that of Fiji would depend on favorable developments in the terms of trade. In addition, the authorities would have to make a substantial adjustment in their economic policies in order to strengthen the country's medium-term growth potential. In that context, particular importance should be attached to the continued moderation of urban sector real wages and to increasing domestic resource mobilization.

The authorities were to be commended for having shown the strong political will needed to introduce a wage freeze in 1985, but it was only the first step in the needed adjustment in the wage area, as real wage increases had exceeded productivity gains for a number of years, Mr. Fujino continued. Continued wage moderation would be the most effective means of increasing employment opportunities and restoring business profits. He hoped that the authorities would firmly resist pressures for a catch-up increase in 1986, and Mr. Ismael's statement that the authorities had intended to continue the present wage freeze until a new wage guideline was agreed upon was encouraging. That the new wage guidelines proposed by the Government took into account changes in the terms of trade and productivity as well as consumer price inflation was welcome.

Additional domestic resource mobilization was needed to finance the desired increase in investment spending, Mr. Fujino said. He welcomed the revenue measures introduced in the 1986 budget, including the widening of the indirect tax base, which would contribute to a further reduction in the fiscal deficit. The authorities intended to shift the burden of taxation from direct to indirect taxes. Accordingly, they should seriously consider the possibility of introducing a simplified sales tax, as suggested by the staff, in order to broaden further the tax base and to strengthen the tax administration by simplifying the tax structure. On the expenditure side, the authorities had recently decided to continue the hiring freeze and the restraint on the wage and salary bill for civil servants in the 1986 budget, moves which seemed to be consistent with the staff's recommendations.

Private savings could be increased by augmenting the contributions to National Provident Fund, something that the authorities were contemplating, Mr. Fujino remarked. He agreed with the staff on the need to strengthen the banking services in the rural sector in order to deepen the financial sector.

The recent tightening of monetary policy seemed to have made a significant contribution to price stability and external adjustment in 1985, and he hoped that the present monetary stance would be maintained in the coming period, Mr. Fujino said. The recent rapid increase in loans by the Fiji National Provident Fund had helped to divert public enterprise demand for credit from the banking system. That development should permit a larger share of bank credit to be directed toward private investment activities.

The Fiji dollar had appreciated in effective terms during the first half of 1985, as the Australian dollar had weakened and then depreciated in recent months, while the U.S. dollar had weakened, Mr. Fujino noted. Those developments seemed to suggest that the share of the U.S. dollar in Fiji's currency basket was excessively large, and he welcomed the authorities' ongoing review of the composition of the basket; they were wisely considering leaving out foreign debt from the weighting formula.

In his opening statement Mr. Ismael had noted the authorities' concern about the World Bank's strategy regarding the Bank's involvement in the Pacific Island countries, Mr. Fujino remarked. The World Bank staff should comment on the reasons for the institution's adoption of that strategy.

Mr. Govindarajan said that basically he agreed with the staff appraisal. Apparently the authorities also generally agreed with the staff's assessment of the economy's performance in 1985 and the prospects for the economy in the coming period.

The economy had grown by an average rate of 5 percent a year in the 1970s but had faced various economic problems during recent years, owing mainly to exogenous factors, such as the prolonged drought, severe cyclones, the recession in Fiji's major trading partners, and the significant deterioration in the terms of trade, Mr. Govindarajan continued. The rate of economic growth in the 1980s had averaged only about 1 percent a year. To improve that performance the authorities had taken a number of steps in 1982-84 which were described on pages 2 and 3 of the staff report.

Fiji's performance in 1985 was mixed, Mr. Govindarajan went on. Real GDP was estimated to have declined by about 2 percent, owing mainly to the effects of the cyclone, including a reduction in sugar output, foreign export receipts, and tourist arrivals, which normally accounted for a substantial portion of Fiji's total foreign exchange earnings. In addition, the terms of trade had deteriorated by nearly 14 percent, resulting in a decline in per capita income of 7 percent in 1985. At the same time, the level of unemployment had remained high even though real wages had been declining substantially, owing mainly to the courageous wage freeze policy that the authorities had adopted. The rate of inflation was estimated to have been reduced to below 5 percent in 1985, and the external current account deficit had been reduced from 9.4 percent of GDP in 1982 to 3.7 percent in 1984 and was estimated to have remained at 3.7 percent in 1985.

Despite the tight fiscal, monetary and other policies that the authorities had maintained over the previous several years, economic performance was expected to remain fragile in the medium term, Mr. Govindarajan remarked. He was pleased that the authorities were fully aware of the problems facing the economy and planned to take suitable steps in 1986 to further improve the economic situation, including an increase in revenues in FY 1986 and a freeze on new recruitment and wage increases, all bold steps for which the authorities were to be commended. The authorities were in the process of implementing several recommendations by the Financial Review Committee which were designed basically to increase the efficiency of the Government. In addition, as the staff had recommended, the authorities had established a Public Enterprise Unit, which was expected to undertake in the near future a systematic evaluation of the performance of public enterprises. All those steps were positive and should result in further improvements in Fiji's performance.

The authorities faced an interest rate policy dilemma: a reduction in interest rates was needed to encourage investment, but that step could adversely affect the level of savings and result in capital flight, Mr. Govindarajan noted. He wondered whether the staff had any views on the best means of balancing the authorities' various significant policy objectives.

It was his impression from the staff report that the existing currency basket was not working properly, Mr. Govindarajan commented. The staff had remarked that it was hoped that a more appropriate set of currencies and currency weights would be chosen so that those variables would be more consistent with the authorities' external objectives. A further staff comment on that matter would be helpful.

The most worrying aspect of recent developments in Fiji was the lack of growth and employment opportunities despite the authorities' commendable adjustment efforts, Mr. Govindarajan said. That trend underscored the need to strengthen the economic structure in order to achieve viable economic growth in the longer run. To that end, an increase in investment would be essential, as it would help to diversify the economic base and to increase employment opportunities. Gross investment as a percentage of GDP had fallen from 25.6 percent in 1982 to 18.8 percent in 1985, and despite the authorities' various efforts, that ratio was unlikely to reach 21 percent in 1986. The benefits that had been achieved by the adjustment efforts should not be placed in jeopardy through an increase in government spending, but an increase in the rate of economic growth and in investment at the present stage seemed to be of paramount importance, and the authorities' wished to seek assistance from multilateral institutions should be supported. He too had noted Mr. Ismael's concern about the World Bank's involvement in Fiji. It was surprising that the World Bank had made no new commitments in Fiji in the previous four years, even though the authorities had introduced substantial adjustment measures in that period. A further comment on that development would be helpful. He wondered whether the World Bank had assessed Fiji's requirements under the Ninth Development Plan and whether the World Bank had its own plans for assisting Fiji in the coming period.

Mr. Fox stated that he agreed with much of the staff appraisal. Mr. Ismael's opening statement showed that the authorities were well aware of the key policy issues. The most pressing problem was the high level of unemployment, and the authorities understandably wished to promote even faster economic growth than the 4 percent rate expected in 1986. However, the staff and the authorities had agreed that the external position remained fragile, and the staff's medium-term projections showed the danger in trying to achieve too much too quickly. A cautious approach was particularly needed in the light of the uncertainties about the staff's assumptions concerning external factors, especially the recovery in the price of sugar. The staff should comment on the possibility and implications of a substantially lower world sugar price than the staff had assumed. There was scope for boosting exports through the implementation of sensible investment projects, such as the modernization of the Fiji Sugar Corporation--which had run increasingly large losses--and the effort to increase hotel capacity. However, such investment must go hand in hand with a further strengthening in public sector finances if the desired reduction in the external current account deficit was to be achieved. The staff's various recommendations in the appraisal were fully appropriate, and he was pleased that some of the recommendations had already been adopted.

He wondered how the smaller budget deficit projected by the staff in 1986 was to be achieved, Mr. Fox said. The authorities had heeded the staff's advice and, contrary to earlier expectations, had extended the freeze on civil service recruitment and wages. However, he wondered whether the civil service pay freeze, like the freeze in the private sector, was merely a temporary measure for the period until an agreement was reached with the trade unions on a new set of guidelines for de-indexing the wage bargaining system. In other words, wages would increase in 1986 if agreement was reached. A wage freeze throughout 1986 would result in the further adjustment in real wages which the staff considered was crucial to improving employment prospects. The staff's estimate of the required overall adjustment in real wages would be helpful.

The staff should comment on the implications of the sharp rise--by one third--of the lower income tax thresholds, Mr. Fox commented. The revenue effects of that move might be less than the effects of the originally proposed 20 percent reduction in individual income tax rates and could be partly offset by the introduction of a turnover tax. Nevertheless, the reduction in the lower income tax thresholds represented a major shrinking of the tax base and might well lead to a decline in tax elasticity. The staff should comment on the implications of the five-year tax moratorium that had been given to sugar farmers.

He tended to endorse the authorities' preference for maintaining interest rates at current levels in order to encourage private savings, Mr. Fox said. However, he agreed with the staff that, in the medium term, such interest rates would not be sufficient to encourage a sustained rise in savings in the absence of a strengthening of banking services in the rural sector.

The staff had mentioned that possibility of creating a free trade zone in Fiji, Mr. Fox remarked. He wondered whether experience elsewhere gave a clue as to the scope for such a project in a small and geographically isolated island.

Mr. Romuâldez said that he shared the authorities' concern about the World Bank's policies in the South Pacific island countries. His chair had expressed that concern on several previous occasions in discussing the needs of members of his constituencies, including Western Samoa and the Solomon Islands. The issue of the World Bank's policies concerning the South Pacific island countries was particularly relevant because of the current emphasis on cooperation between the Fund and the World Bank. Finally, he fully agreed with the staff appraisal.

The staff representative from the Asian Department commented that wage policy made an important contribution to the authorities' short-run efforts to stabilize the economy and that further adjustments in wages would be particularly important at the present stage in increasing the potential for employment. The staff had made a substantial effort to gauge the required reduction in real wages, but it was rather difficult to obtain an accurate estimate because of the inadequacy of data. The staff had also asked the authorities to estimate the effect of the wage freeze on employment. The authorities had understandably had difficulty in making that estimate. Nevertheless, it was clear that over the previous several years wages in the urban sector had risen much more rapidly than productivity gains; that was the main cause of the difficulty in increasing private sector employment, and real wages would therefore have to be reduced. The authorities had proposed a nominal increase of only two percent in the coming year when wage guidelines were to be approved by the various parties and the wage freeze was to be lifted. That nominal increase would result in a reduction in real wages of about 3 percent, an amount that was not sufficient to close the gap between real wages and the economy's ability to pay wages.

The authorities faced an interest rate policy dilemma, the staff representative remarked. At the present juncture, interest rates could not be reduced, and thus could not play a role in encouraging investment. Therefore, investment would have to be supported by other means. For example, public sector investment could stimulate overall economic activity, which in turn would stimulate private investment. In addition, credit could be diverted to the private sector if public sector enterprises could borrow more from the Provident Fund.

The income tax reduction together with several other measures to reduce the tax burden were expected to lead to a reduction in potential tax revenue of F$16 million in 1986, the staff representative said. That amount would be more than offset by the expected F$28 million in potential tax revenue gains through various excise tax and import duty changes. Accordingly, the overall budget deficit would be reduced by F$13 million, and, as a percentage of GDP, the deficit was expected to be 1 percentage point lower in 1986 than in 1985.

Various tax concessions had been made to farmers and other low-income groups, the staff representative noted. The general public had been arguing strongly that the high income tax rates had reduced incentives to work, and the Government had responded by providing concessions to persons in the lower income brackets and to farmers. Those concessions also would meet the demand by the public in the rural sector to reduce the large wage differential between urban and rural wages. The staff saw no difficulty in the steps that the authorities had taken to reduce that differential.

The staff had encouraged the authorities to review and make adjustments in the contents and weights in the currency baskets so that exchange rate policy would be more consistent with the authorities' external objectives, the staff representative commented. The authorities recognized that the U.S. dollar had been given an excessively large weight in the currency basket, mainly because the authorities had taken into account the external debt denominated in U.S. dollars in their management of the exchange rate basket; that approach to managing the basket was clearly not the optimum one. The authorities were attempting to reduce the weight of the U.S. dollar and to include additional currencies in the basket which were more relevant in terms of Fiji's external transactions, including trade and tourism. More appropriate currencies and weights would enable the authorities to improve their management of the nominal effective exchange rate. The authorities should continue their flexible exchange rate policy in order to maintain external competitiveness.

Fiji had had a special arrangement with the United States, European Community (EC) countries, and neighboring countries through long-term contracts under which the actual sugar price charged by Fiji had considerably exceeded the world market price, the staff representative of the Asian Department remarked. Even if the world market sugar price were much lower than the staff had projected, the long-term contract price for Fiji would not be affected in the immediate future. In the longer run, of course, Fiji's contract price would be adjusted in line with changes in the world market price, but for the coming three or four years, Fiji's sugar price would not be affected by fluctuations in the world market price. Therefore, even if the world market sugar price were lower than the staff had assumed, Fiji's balance of payments position was not likely to be much different from the one that the staff had projected in its medium-term scenario.

The staff representative from the World Bank said that there seemed to be a mistaken impression that the World Bank was either unable or unwilling to lend to Fiji. Over the previous year the World Bank staff had held high-level discussions with Fiji officials in Fiji, at the World Bank, and during the 1985 Annual Meetings on a substantial program of cooperation between the World Bank and Fiji. It was true that from 1981 to mid-1985 the World Bank had not made any loans to Fiji, but that outcome had been due not to the World Bank's unwillingness to lend to Fiji but rather to the Fiji Government's decision to borrow relatively little abroad; the necessary foreign exchange receipts had been available largely through grants or from soft money sources. In that period the World Bank had considered a loan to Fiji for tree crop development, but the Government had decided not to pursue that project. The World Bank, together with the Asian Development Bank, had made a loan of $6.5 million to Fiji several months previously. The World Bank was also working with the Asian Development Bank on a substantial road improvement project in Fiji; a joint mission was scheduled to visit Fiji in January 1986.

The World Bank was developing projects outside its cooperative effort with the Asian Development Bank, the staff representative from the World Bank remarked. The World Bank was currently discussing with the Fiji Government possible telecommunications and education projects, and the World Bank had just received a letter from the Deputy Prime Minister and Minister of Finance in which he had stated that he would wish to explore possible agricultural projects. In sum, the World Bank was keen to reach agreement with the Government on a substantial program of cooperation that would involve World Bank lending. As a part of the World Bank's economic and sector work in Fiji, the institution was sending a team to Fiji in March 1986 to study the possibilities for promoting industrial exports. That mission would also discuss with the authorities the appropriate means of following up on the Government's request for assistance in monitoring and evaluating public sector enterprises.

Mr. Ismael said that the authorities' successful management of the economy was attributable partly to their close relations with the staff and partly to the authorities' determination to stabilize the economy. The staff's recommendations carried considerable weight in Fiji and were often implemented by the authorities. There had been only 11 months between the 1984 and 1985 Article IV consultations, as the authorities had wished to take the staff's proposals into account in drafting the new budget. Article IV consultation discussions were an important source of economic analysis and policy advice for small members like Fiji. The Fund had also played an important role in policy formulation in Fiji by providing technical assistance that had proven invaluable in improving revenue collection and in increasing the effectiveness of monetary policy. The authorities would need additional technical assistance to improve further their management of the economy, and the Fund should stand ready to provide it. The authorities had shown great political courage in maintaining an incomes freeze despite the strong opposition of the trade union movement. The authorities' determined approach to economic management augured well for the future.

His comments on the World Bank's policy toward the Pacific island countries were based partly on the World Bank's report No. B-4112/FIG, issued in June 1985, Mr. Ismael remarked. That report had mentioned that the World Bank's strategy for the Pacific island countries was to take the lead in economic and sector work while cofinancing most operations with the Asian Development Bank, which was the lead agency responsible for project preparation, appraisal, and supervision in that region. His criticism of the World Bank was not a new one; Mr. Rye's chair had also complained about the World Bank's policy during Executive Board discussions on Western Samoa. Nevertheless, the Fiji authorities had maintained good relations with the World Bank staff.

The Acting Chairman made the following summing up:

Executive Directors noted that the setback to economic growth in 1985 was caused largely by unfavorable weather conditions that exacerbated a deteriorating economic environment caused in part by the sharp decline in the terms of trade in recent years. Unemployment continued to increase against the background of a stagnant economy. In this context, Directors commended the authorities' policy response, including the comprehensive wage freeze implemented from late 1984 and the tightening of monetary policy in 1985. The rate of inflation declined further to a moderate level, and the external payments position improved in part because of these adjustments in wage and monetary policy, but also because of temporary factors.

Nonetheless, in spite of the decline in inflation and the external adjustment, Directors expressed concern about the structural weakness in the external payments position and its medium-term outlook, and they encouraged the authorities to make further substantial adjustments in policies. With regard to wage policies, the 1984 wage freeze was seen as an appropriate first step in light of the increases in real wages in recent years over and above the productivity growth. In addition, and more importantly, Directors welcomed the Government's intention to sever the rigid links between wage adjustments and price inflation and to take account of productivity growth and changes in the terms of trade in formulating new wage guidelines. These guidelines should be consistent with promoting employment and achieving the Government's targets for growth and balance of payments viability.

In the area of fiscal policy, Directors welcomed the noticeable reduction in the budget deficit envisaged for 1986 and the shift away from current to more efficient capital spending. They also noted that limiting the growth of the government wage bill would be fundamental to the improvement of the overall fiscal position. Regarding government revenues, Directors welcomed the recent revenue measures and stressed the importance of broadening the tax base in order to strengthen the elasticity of the tax system. The need to improve the financial position of public enterprises was also noted.

Directors supported the present stance of monetary policy and noted that this provides for broad money to increase in line with the expected growth in nominal GDP and with the balance of payments target. They recommended that in order to promote savings, present interest rate levels, which are positive in real terms, should be maintained, as intended by the authorities, while banking services in rural areas should be expanded. While the recent increase in competition among commercial banks was welcomed, a further increase in competition and strengthening of the banking system would enhance the efficiency of the financial system.

Directors welcomed the recent introduction of a more flexible exchange rate policy. In this context, they welcomed the recent depreciation in the effective exchange rate of the Fiji dollar in both nominal and real terms and emphasized that the authorities should continue to use a flexible exchange rate policy in order to maintain a competitive economy. In this regard, it was suggested that the authorities review the weights in the exchange rate basket. With regard to commercial policy, Directors recommended a review by the authorities of the present system of tariffs and quotas in order to increase the openness and efficiency of the import substitution sector in the economy.

Some Directors considered that public and private investment should be increased to promote growth and employment and to strengthen the structure of the economy. In this context, most speakers saw the need for a greater role for the World Bank. Some of them noted that the World Bank had made no new commitments in Fiji over the previous several years and remarked that that outcome was perhaps the result of the Bank's policies on the Pacific island countries. A few Directors said that they hoped that the World Bank would assess the resource requirements for and actively support the implementation of the Ninth Development Plan. Some Directors stressed that accelerated investment and growth must be achieved without jeopardizing the gains achieved in economic stabilization.

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

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/85/184 (12/20/85) and EBM/85/185 (12/20/85).

2. MALAWI - EXTENDED ARRANGEMENT - WAIVER OF PERFORMANCE CRITERION

Malawi has consulted with the Fund in accordance with paragraph 4 of the extended arrangement for Malawi (EBS/83/183, Sup. 1, 10/13/83). The Fund finds that, in view of the circumstances described in EBS/85/274, dated December 11, 1985, no additional understandings are necessary pertaining to the non-observance of the ceiling on net domestic assets of the banking system referred to in paragraph 3(a) of Executive Board Decision No. 7981-(85/77), 5/22/85 and that Malawi may proceed to request purchases under the extended arrangement. (EBS/85/274, 12/11/85)

Decision No. 8157-(85/185), adopted
December 20, 1985

APPROVED: AUGUST 14, 1986

JOSEPH W. LANG, JR.
Acting Secretary