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CONCEPTS PAPER

DOMINICA CASH TRANSFER

UNITED STATES OF AMERICA

THE REGIONAL DEVELOPMENT OFFICE
TO THE CARIBBEAN (RDO/C)

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Recommendations and Summary

Recommendation

It is recommended that this concept paper be used as the basis for a delegation to the Director, RDO/C to approve the Program Assistance Approval Document (PAAD) and to authorize an Economic Support Fund Grant of $2.5 million to Dominica. The Grantee will be the Government of the Commonwealth of Dominica (GOCD) acting through the Ministry of Finance.

Program Summary

The grant will be used to help Dominica cope with its short run liquidity problem and to encourage the Government to immediately begin the design of a structural adjustment program. An acceptable medium-term program is a precondition to accessing concessional structural adjustment funds available from the multilateral donors. Such structural adjustment support will not be available before the end of Dominica's current fiscal year, which ends June 30, 1986. The first $1.5 million tranche of the Economic Support Fund grant will be disbursed in June, 1986. It will enable Dominica to enter a structural adjustment program without being encumbered by additional nonconcessional debt that would merely add to its need for support thereafter.

Specific Conditionality requirements in this Grant therefore focus on assuring adequate progress in designing a comprehensive stabilization program as a precondition for a subsequent structural adjustment effort.

Background

In September, 1983, AID authorized a $2 million cash transfer to cover GOCD's fiscal 1983/84 financing gap. Despite a tax effort which has increased the revenue/GDP ratio from 23% in fiscal 1979/80 to 31% in 1984/85 and expenditure controls which have reduced current expenditure from 40% of GDP to 31% during the same period, GOCD projects a EC$9.5 million (US$ 3.5 million) financing gap for fiscal 1985/86. In addition, the Government of Dominica is in arrears in its obligations to regional and international organizations by approximately $1.7 million. The country has experienced a substantial economic recovery since the hurricane devastation of 1979 and 1980, but repeated storms and fiscal constraints have limited GOCD's ability to keep up with the economy's infrastructure needs while attempting to maintain a manageable debt service burden. The support grant will be to enable GOCD to continue to support the country's productive sectors without incurring debt service burdens that will intensify its financing problems in the future.

Program Objectives

The immediate program objective is to enable GOCD to avoid a short-term fiscal crisis by helping it to cover its financing gap while keeping its nonconcessionary obligations at a manageable level. The alternative is to cut its Public Sector Investment program, thereby undermining the country's long-term growth prospects. The proposed strategy will provide AID with the opportunity, through policy dialogue and technical assistance, to assist the Government of Dominica in moving toward a longer-range development perspective with a more systematic approach to assigning Public Sector Investment priorities. It will furthermore provide assistance during a transitionary period when GOCD can examine its revenue and expenditure structures and prepare reforms which will put its finances on a more sound footing for sustainable longer term fiscal solvency.

Program Setting

The present Government of Dominica has made substantial progress and has made some politically unpopular decisions in its efforts to regain control of a fiscal situation that was out of control at the time it took office in 1980. Three hurricanes had eroded the tax base, British budgetary assistance had been phased out and large wage and salary awards to public employees had placed the government's finances in a precarious situation. Under the IMF's Extended Fund Facility, the revenue base was broadened, taxes were raised, and the revenue collection mechanism was strengthened. Better management of public enterprises, increases in their tariffs and a reduction in subsidies to them have greatly reduced the drain of parastatals on the budget.

GOCD shares in large measure AID's views on the importance of privatization and is taking steps to privatize enterprises as rapidly as the availability of private buyers will permit.

Despite the additional strains placed on it by IMF repurchases, the government's fiscal situation improved so that there was a small current account surplus in 1984/85. Official 1985/86 projections are for a current account surplus but an overall fiscal gap of US$4.3 million (3.5 with deferred investment). ECCB and commercial bank borrowing ceilings have been nearly reached.

Performance under the IMF EFF was quite good. The tax base was broadened, and revenue collections improved. These changes were instrumental in reducing government deficits. Government entered into an IMF standby in 1984/85. Because Government exceeded the programmed ceiling on nonconcessionary borrowing, it was not able to make all the drawings under that standby. At the March 12, 1986 CGCED VII Dominica Subgroup meetings, the IMF representative emphasized that Dominica will require more concessional assistance over the next two years, extending to the medium term if donors are to help Dominica reach self-sustained growth, and yet keep debt service at a manageable level. The alternative is to cut the Public Sector Investment Program, which has only recently been upgraded. The IBRD and IMF will begin discussions with the Government of Dominica in May with respect to a government request for assistance. Dominica will be the first OECS country to enter into a structural adjustment program under the "Tight Consultative Group" (TCG) concept. While the program will likely be developed by July 1986, TCG discussion will probably not be held until January, 1987. Therefore, even if an agreement is reached, disbursement will not come early enough to relieve Dominica's immediate financial pinch.

Previous Program Assistance

IMF Extended Fund Facility

In 1981, the government of Prime Minister Charles negotiated a three-year, $11 million EFF agreement with the IMF. The core of the EFF agreement, a portion of whose proceeds was used to finance the civil servants' salary arrearages, was fiscal prudence. Limits were placed on the overall budget deficit and the current account deficit was targeted for reduction from 18 percent of GDP to balance. In order to avoid "crowding out" of private investment, limits were placed on government borrowing from commercial banks. Major elements in that program included fiscal reforms to improve government finances, including: revisions of customs tariffs; an increase in the foreign exchange tax; imposing hospital fees and charges; increase in consumption fees on fuels; limiting current Central Government spending to EC67.2 million, with capital expenditures of EC$43.3 million; reorganization of public enterprises, especially in the banana industry; increased water tariffs; and a wage guideline of 10 percent for government workers. Transfers from the treasury to public enterprises were eliminated. Government performance under the EFF was good. Payments were on time, and agreed-upon reform measures were undertaken. Under the 1983/84 program, government was unable to draw its April quota because it exceeded the programmed ceiling on nonconcessionary borrowing. This occured first because an unseasonable Spring storm required emergency spending and second because of substantial tax refunds that the government wanted to make before the end of the fiscal year, which had an unintended effect on nonconcessional borrowing. By September, they were back on stream and were able to draw the remaining balance of the EFF. The EFF expired on February 5, 1984, and certification was provided that GOCD had satisfied all performance criteria.

IMF 1984/85 Standby

In 1984/85 the government negotiated a standby arrangement with the IMF for SDR 1.4 million. That standby had to be suspended in February of 1985. On that occasion bad weather made it necessary to spend one million EC dollars to restore damaged communications. The Fund wanted further government to reduce expenditure, involving further reductions in civil service positions after 200 had already been cut. The government felt that it could not agree to this because first, it would have been politically explosive and secondly, because it would have been costly at the outset because of the need to give severance pay. Failure to reach agreement on this issue led to suspension, after approximately 1.1 million of 1.4 million SDR's had been drawn. The budget current account continued to improve, and showed a small surplus in 1984/85.

1983/84 AID Cash Transfer.

On September 30, 1983 AID signed a Grant Agreement with the Government of Dominica, providing $2 million in funds through cash transfer. The goal was economic stabilization. The objective was to "support GOCD's extraordinary efforts to rationalize its economy through economic policy reforms consistent with IMF, IBRD, and AID recommendations." The major purpose was to eliminate a projected FY1983/84 capital account deficit, and the balance of payments gap that was a direct outgrowth of the fiscal deficit. The list of public sector development activities to be supported by the Government included twenty-five activities, falling into 3 categories: 12 in Agricultural Diversification, 4 in Economic Infrastructure, and 9 in Social Infrastructure.

Conditionality was derived from the premise that for the most part, GOCD employed sound economic policies, that use of administered prices or exchange controls was not pervasive, and that the operations of the ECCB do not permit it to print money to finance government expenditures. At the time, GOCD was already operating under the $11 million dollar IMF Extended Fund Facility that had been introduced in 1981. The AID cash transfer was disbursed in three tranches, each of which was conditioned on GOCD being in substantial compliance with the EFF Agreement, and that the local currency aspects of the AID Program were proceeding satisfactorily.

Since the third tranche of the cash transfer had not yet been disbursed, the timing of the end of the EFF, prior to the planned disbursement date of the third tranche of AID funds, meant that de facto, conditionality for the third tranche had already been met. Performance criteria for the cash transfer were met, and 23 of the 25 public sector development activities were completed.

Since then, the Government of Dominica has continued to work to improve its operations. It has requested, and is receiving under RDO/C's Public Management and Policy Planning Project (PMPP), Technical Assistance in the form of a Tax Advisor and for a person to assist in economic planning. PMPP resources will continue to be available for future technical assistance needs.

Program Description

Introduction

Dominica has made very significant progress in macroeconomic performance, in balance of payments performance, and in its public finances under the Government of Prime Minister Charles. After the devastating hurricanes of 1979/80 until 1984 annual GDP growth averaged nearly 4 percent, the balance of trade deficit has been reduced from 74 percent of GDP to 25 percent, and the central government's current account deficit moved from an equivalent of 10 percent of GDP in 1980/81 to near balance in 1984.

However, Dominica still has a backlog of infrastructure to make up, and an ambitious Public Sector Investment Program that will be a critical element in supporting private sector growth in future years. Despite a tax effort which has increased the revenue/GDP ratio from 23 percent in 1979/80 to 31 percent in 1984/85, and a reduction in current expenditure from 40 percent to 31 percent of GDP in the same period, government finances continue to be strained. In 1983/84, Dominica received $US 2 million in program support from AID. In 1984/85, the government borrowed on nonconcessionary terms to finance its financing gap.

The Need for Budgetary Assistance

Additional budget demands this year have produced an unfinanced gap for fiscal 1985/86 which the government estimates at 9.5 million EC (3.5 million U.S.) dollars. This gap remains after government reduced its contribution to public investment by 2.1 million EC dollars, borrowed up to its chartered limit from the Eastern Caribbean Central Bank (ECCB), and exceeded its overdraft facility at local commercial banks by 1.7 million EC dollars. If it does not receive some assistance during the current fiscal year, which ends June 30, the government will face a cash flow crisis. It is able to cover virtually all of its obligations except debt repayment to ECCB and the IMF and a buildup of reserves.

In the long term, Dominica is working toward policies which will expand investment and exports, which will increase public sector savings, and which will restrain growth of the public sector. Despite government's best efforts, financing a public sector investment program sufficient to help the economy reach a self-sustaining growth rate will require substantial foreign capital inflows. Government's long term contribution to this process will be undercut if it must now resort to further reducing its PSIP in order to cover its short term financial needs, or if it must resort to nonconcessional financing which will add to its already growing debt service burden.

It is expected that in May, 1986 Dominica will be the first OECS country to negotiate a medium-term structural adjustment program under the new "Tight Consultative Group" (TCG) concept (see Annex B). Under this coordinated approach, program assistance will likely be available from the IMF under its new "Structural Adjustment Facility" (SAF), from reprogrammed World Bank IDA VII funds and from program and project assistance from other donors. In early May the World Bank will negotiate with the Government of Dominica and within a few days call in the IMF and other analysts to carry out an assessment. It is expected that agreement on a medium-term program can be reached by early July. January 1987 is the likely time for the program to be tabled for discussion in the TCG. The terms and conditions of that program cannot be accurately anticipated at this time, but it is certain that if agreement is reached, disbursement will not be made before the end of Dominica's current fiscal year (June 30), and will therefore not assist them in their present cash flow crisis. U.S. Program assistance which will include at least one disbursement during Dominica's fiscal 1985/86 will support the transition to such a medium-term structural adjustment program. A more detailed Balance of Payments and Fiscal Analysis follows.

Present Balance of Payments Situation

Dominica does not face an imminent balance of payments crisis. The (perhaps optimistic) IMF projections in Table 1 indicate that the country could experience reduced deficits, and even surpluses, in its balance of payments until 1990. This scenario, however, hinges critically on the ability of Dominica to successfully upgrade production for export in its agriculture and manufacturing sectors, to attract increasing flows of private investment, and to maintain prudent public sector policies.

Inflows of the foreign goods required to support private and public investment at levels sufficient to generate solid growth rates will probably continue to produce trade deficits. It is unlikely that domestic savings will be sufficient to support the needed private and public infrastructure at any rate, so that concessional foreign capital inflows will be required to supplement domestic savings. In order to keep this dependance on foreign capital at a manageable level, attention must be focused on expanding exports and on limiting the growth of imports. Export growth will have to center on agriculture and on light manufacturing. In order for agriculture to compete in international markets, productivity improvements must be forthcoming in traditional products, and diversification must take place in order to reduce the dependence on established regional markets that has slowed the economy in the past two years.

Recent performance of the traditional agriculture subsectors has been disappointing. Despite measures which have improved the marketing of bananas, and which have improved farmer efficiency, production has fallen below targets. The accompanying projections assume that Dominica will be able to increase its exports of bananas from the present 33,000 tons to over 46,000 tons by 1990. To achieve this, grower prices will have to be improved to increase production incentives. Government is currently attempting to renegotiate the industry's debt to commercial banks, in order to reduce the debt burden and thereby increase the net price to farmers by 3 EC cents per pound. Improved use of fertilizer and pesticides and better management techniques will need to be introduced. Coconut production has been restored to pre-hurricane levels, and further expansion is anticipated. This will require new access roads and technical assistance. There is some promise that Dominica will be able to make further inroads into regional citrus markets.

Diversification will be required in order to move into new markets. Government is divesting lands and making them available to those who can put them to effective use. Market identification, introduction of new products, increased foreign investment, and technical assistance will all be required if the potential of newly settled farmers is to be realized. This assistance will be available on a project basis from USAID and from other donorss

The recent performance of the industrial sector has also been disappointing. Government will have to explore ways that give incentives to investors without unnecessarily eroding the revenue base. Tax, licensing, customs, and other public policies should be reexamined in the context of their impact on investor incentives. The Public Sector Investment Program should be carefully tailored to meet the infrastructure needs of the private sector. The present government has been favorably disposed to the private sector. The balance of payments can be maintained on sound footing if the government continues to seek and to cooperate with private investors who can lead a diversification effort in agriculture and in manufacturing.

Table 1
Dominica: Balance of Payments
(Million U.S. Dollars)

	1980	1983	1984	Prel. 1985	Proj. 1986	Proj. 1990
CURRENT ACCOUNT BALANCE	-14.9	-5.5	-4.8	-4	-6.8	-4.3
Trade Balance	-43.5	-19.6	-30.2	-26.8	-24.7	-21.3
Exports, f.o.b.	9.7	27.5	25.6	28.4	31.2	44.3
Imports, c.i.f.	-53.2	-47.1	-55.8	-55.2	-55.9	-65.6
Tourism (net)	1.7	2.9	3.6	3	3.2	3.9
Other Services (net)	-0.2	-1.7	-2.5	-3.7	-3.2	-2.4
Insurance Receipts	2.7		0.5	-0.3	-0.4	0
Private Transfers (net)	6.3	8.5	9.4	9.4	9.6	11.5
Official Grants	18.1	4.4	14.4	14.4	8.7	4
CAPITAL ACCOUNT BALANCE	10.9	1.1	7.9	6.7	8.8	6.5
Central Government Borrowing	0.8	2.7	3.9	2.9	1.9	2.1
Rest of Public Sector Borrowing	0.7	2.6	0.9	3	5.5	2.2
Commercial Banks	2	-2.4	3	-1.2	-1.1	-1
Direct Investment	0	0.2	1.6	1.7	2	3
Short-term capital, errors and omissions	7.4	-2	-1.5	0.3	0.5	0.2
SDR Allocation	0.3					
OVERALL SURPLUS (+) OR DEFICIT (-)	-3.7	-4.4	3.1	2.7	2	2.2
FINANCING	3.7	4.4	-3.1	-2.7	-2	-2.2
Change in official reserves	4.2	3	-3	-1	-0.5	-1
Change in Foreign Assets	-0.5	-0.4	0.2	-0.2	-0.2	-0.2
Net Purchases from IMF	0	1.8	-0.3	-1.5	-1.3	-1
			(In percent of GDP)			
Exports	16.5	35.2	30.0	31.4	32.8	35.8
Imports	-90.3	-60.3	-65.3	-61.0	-58.8	-53.0
Price-sensitive imports	58.2	51.2	43.9	41.9	47.6	48.1
Trade balance	-73.9	-25.1	-35.4	-29.6	-26.0	-17.2
Current Account balance	-25.3	-7.0	-5.6	-4.4	-7.2	-3.5
Overall balance	-6.3	-5.6	3.6	3.0	2.1	1.8
GDP (in U.S. Dollars)	58.9	78.1	85.4	90.5	95.1	123.8

Source: Ministry of Finance, and IMF Staff Estimates, February, 1986

Central Government Finances, 1985/86

The Government of Dominica's stated goal is to improve public sector performance with the aim of generating sufficient budgetary savings to service its external debt and to contribute to the capital development program. To that end, the 1985/86 budget included a series of tax reforms aimed at providing incentives for private sector savings and investment and controlling consumption expenditure. Nuisance taxes were removed and taxes on nonessential consumer items were increased. The result was a planned increase in revenues of EC$9.4 million, which would have increased tax effort from 31 percent to nearly 34 percent of GDP. A planned surplus on current account of $10.1 million EC dollars would have permitted contributions to capital projects and a repayment of 4.9 million to the IMF. This would have left a financing gap of EC$3 million. Several events intervened to alter these plans and to generate the present cash flow problem. First, a November 1985 storm caused damage that required additional expenditure of EC1 million dollars. It was determined that a new ad valorem customs charge significantly increased production costs and discriminated against manufactures. Government felt it necessary to reduce the ad valorem rate. Economic stagnation lowered demand with a resultant drop in consumption taxes. Despite a concerted effort to restrain the public wage bill, threat of a protracted strike led government to concede a civil service wage increase of approximately 20 percent over three years. While this was a substantial improvement over the 47 percent increase that the union had demanded for the first year, it nonetheless added 8.5 million EC dollars to the current wage bill and about 5 million in future years. The originally estimated current account surplus was therefore reduced from 10.1 million to about 3 million EC dollars.

Table 2 contains comparative data on the Government of Dominica's fiscal performance since 1980, and includes its official estimates of a 9.5 million EC dollar fiscal gap for 1985/86, and a 10.2 million dollar gap for FY 86/87. The 9.5 million excludes 4.5 million dollars in arrearages to regional and international institutions. The gap is being partially financed by drawings on the ECCB, Social Security, and from overdrafts at the commercial banks. Local contributions to the Public Sector Investment Program have been reduced from 8.4 million to 6.3 million by freezing projects not already under way. No more than approximately 900 thousand dollars of further reductions in PSIP are possible by postponement. Further reductions would have to be obtained by stopping work on already active projects.

Short-term resources include borrowing from the Eastern Caribbean Central Bank. The ECCB charter sets borrowing limits based upon revenues from current and previous years. For FY85/86, Dominica's limit is $EC 4.1 million, which has already been met or exceeded. This is short term debt, and should be repaid within one quarter. GOCD uses this facility to finance its IMF repurchases, and thus feels compelled to make sufficient repayment to fall below the borrowing limit. The government has commercial bank overdraft limits of 8 million EC dollars. As of March 4th, 1986, their overdraft stood at 9.7 million. In addition, there is a special account at the commercial banks that is presently overdrawn by 2 million EC dollars. Dominica's basic quota with the IMF is SDR 4 million. Between 1981 and 1983, GOCD drew nearly US$11 million from Fund facilities. Since 1984, GOCD has made net repayments to the Fund.

Table 2
DOMINICA CENTRAL GOVT OPERATIONS
(Million EC$)

	1980/81	1981/82	1982/83	1983/84	1984/85	1985/86	1986/87
Total Revenue	75.3	69	72.6	90.4	109.8	118.7	115.7
Current Revenue	47.8	56.7	57.7	69.7	74.6	84.1	89.2
Capital Receipts		0.1	0.5	0.2	0.1		0.1
Foreign Grants	27.5	12.2	14.4	20.5	35.1	34.6	26.4
Total Expenditure	89.7	85.7	88.3	104.1	124.2	131.5	136.2
Current Expenditure	65.1	62.7	62.6	69.5	74.5	80.8	85.7
Capital Expenditure	24.6	23	25.7	34.6	49.7	50.7	50.5
(Of Which, Locally Fin'd)	6.9	8.9	4.7	2.1	1.6	8.4	5.4
Current Account Balance	-17.3	-6	-4.9	0.2	0.1	3.3	3.5
Overall Balance	-14.4	-16.7	-15.7	-13.7	-14.4	-12.8	-20.5
Concess. For. Loans (net)	2.3	3.8	7.2	11.4	11.8	6.2	16.9
Bal. after. Concess. Loans	-12.1	-12.9	-8.5	-2.3	-2.6	-6.6	-3.6
Nonconcessionary Financing	12.1	12.9	8.5	2.3	2.6	-5	-6.6
Reserve-type transactions:	9	9	7.5	0.1	-2.7	-4.9	-4.4
IMF (net repurchase)	10.3	8.7	7.6	0.7	-2.1	-4.2	-3.7
SDR allocation	0.7						
Change in Govt. For. Asset	-2	0.3	-0.1	-0.6	-0.4	-0.7	-0.7
Debentures Abroad					-0.2		
Domestic:	3.1	3.9	1	2.2	5.3	-0.1	-2.2
ECCB Borrowing	2			2	2.1	-2.1	-2.2
Commercial Bank	-0.7	4.2	1.8		0.8		
Statutory Bodies	1.7			1.5	2	2.2	
Other	0.1	-0.3	-0.8	-1.3	0.4	-0.2	
Unfinanced Gap	0	0	0	0	0	11.6	10.2
Less: Deferred Investment						-2.1	
Revised Financing Gap						9.5*	10.2

NOTE: AMOUNTS REPORTED HERE BY GOCD FOR FY85/86 CAPITAL EXPENDITURE AND FOREIGN GRANTS ARE CONSISTENT WITH EARLIER IMF REPORTING, BUT HAVE SUBSEQUENTLY BEEN REDUCED TO 37.9 and 26.4, RESPECTIVELY

* DIFFERENCE BETWEEN THIS AND VALUE IN OTHER TABLES DUE TO IMF METHOD OF REPORTING CONCESSIONAL FINANCING, AS USED IN THIS TABLE

SOURCE: GOVERNMENT OF THE COMMONWEALTH OF DOMINICA, MINISTRY OF FINANCE

The fundamental short term fiscal problem is a liquidity shortage imposed by debt servicing requirements. By March, 1986 the government had exhausted its existing short term lines of credit. A liquidity crunch therefore occurs in months when an ECCB or an IMF repayment is due. In February, 1986, it appeared that there would be an EC2.1 million shortfall in funds needed to meet the public payroll after the IMF payment was made. Government employees were notified that their February salaries might be delayed. The crisis was averted by government borrowing 1.2 million in 90 day funds from the Social Security fund, depositing them at ECCB to reduce the net borrowing position, and then borrowing from ECCB to make the IMF payment. An additional 1 million was raised in commercial bank overdrafts.

Table 3 presents estimated cash flows for fiscal 1985/86. The cash flows were generated by RDO/C from data provided by the Dominican government. They show that the unfinanced fiscal gap is nearer EC$ 8.6 million (U.S.$3.2 million) than 9.5 million, excluding arrearages to regional and international organizations*. Further compression of the PSIP could reduce this to EC7.7 million. The data indicate, however, that the fundamental short term problem is not directly related to PSIP, but to attempts to maintain good credit standing by prompt repayment of outstanding obligations. While, on an accrual basis the current account is in deficit by EC1.8 million dollars, on a cash basis it is in surplus by 3.3 million (on a cash basis, current expenditures are 80.8 million versus 85.8 million on an accrual basis). On a cash basis, the balance after borrowing and grants would be in surplus by EC1.7 million, though the accrual value in Table 4 is a deficit of 3.6 million. The fundamental difference between the two is explained by the arrearages in transfers, which do not require immediate payment. Thus the pressure appears to come from the repayment of very short term obligations to ECCB and commercial banks. The repayment to statutory bodies is somewhat less urgent. To meet all of May's accrued obligations would require EC8.6 million (US$3.9 million).

By focussing on the months from March to June, the balance after borrowing and grants indicates that a small 703 thousand dollar surplus in March should offset a 635 thousand dollar deficit in April. If the estimates are correct, the shortfall in June will be relatively small. The most severe shortfall occurs in May, when there is a 1.43 million dollar shortfall in addition to the repayment obligations scheduled for that month. In Table 4, these are implicitly financed by generating unpaid vouchers, to be repaid in June. In order to meet all of May's obligations, 6.0 million EC dollars (U.S. 2.2 million) would be required.

* See footnote on Table 2

The Liquidity Crunch

The Government of Dominica has virtually exhausted its short run borrowing options. The borrowing limits at the ECCB have been exceeded. These limits are tied to the government's current revenue. The limit on treasury bills has been filled for this fiscal year. Another facility allows governments to borrow very short term an amount equivalent to 5 percent of the average of recurrent revenues over last 3 years. This limit has also been exceeded. Furthermore, these are very short-term funds, generally one month. Dominica has somewhat more leniency, in that Government is supposed to repay within one quarter. While it is possible that this can be rolled over, it is not likely that it can be increased further. Moreover, it is important that borrowings from this source be kept below the limit, because Government borrows from this account to make its IMF repurchases (reimbursing the ECCB by depositing withdrawals from the Social Security Fund). Further borrowings from the Social Security Fund are similarly short term expedients which demand repayment, and of course erode the social security system. Further use of commercial bank overdrafts, if granted, still involve very short-term repayment. In short, all borrowing options demand nearly immediate repayment and do not address the fundamental cash flow problem.

If the government does not receive budgetary assistance, its options are: to resort to these sources to the extent that they are available, but each time compounding its short term debt service burden; go into arrearage in salary payments or goods and services purchases, which would de facto take the government back to the situation it inherited in 1980; or close down its ongoing capital projects in a climate of high unemployment and little if any economic growth. Each of these options represents a retrogression that has adverse economic as well as political consequences.

Closing the fiscal Gap

The estimates suggest an overall shortfall of US$3.2 million, concentrated in May and June. The gap can be covered by postponing May repayments until June, when the first $1.5 million USAID disbursement is made, and rolling over portions of the remaining obligations:

	U.S. Millions
USAID Funds	1.5
Retrench remaining PSIP	.3
Partial Rollover of one of other payments	1.4
	3.2

Table 3

Dominica Central Government Operations
1985/86
(EC$000)

	JULY	AUGUST	SEPT	OCTOBER	NOVEMB	DECEMB	JAN	FEB	MARCH	APRIL	MAY	JUNE	TOTAL
SHORT TERM DOMESTIC BORROWING	-193	-144	351	1154	-119	1238	539						
Position, Beginning of Period	9599	9455	9806	10960	10841	12079	12618						2826
RECURRENT REVENUE (CASH BASIS)	6290	6708	6930	7339	5891	8619	7111	6170	8027	7228	6381	7361	84055
Taxes	5327	6512	6075	6608	5458	7302	6229	5649	7602	6437	6042	6513	75754
Direct	1827	2174	1548	2611	1705	2410	2044	1607	3144	2365	1749	1464	24648
Indirect	3500	4338	4527	3997	3753	4892	4185	4042	4458	4072	4293	5049	51106
Nontax Revenue	963	196	855	731	433	1317	882	521	425	791	339	848	8301
RECURRENT EXPENDITURE (ACCRUAL*)	5447	5860	5978	7106	6706	8412	6608	12121	6504	7141	6972	6977	85832
Personal Emoluments	3437	3437	3568	4020	3678	5349	4059	4106	3860	3885	3947	3850	47196
Goods and Services	865	1255	1219	1219	1213	1210	1016	2193	1220	1220	1220	1220	15170
Transfers	598	519	459	857	601	652	826	4724	587	466	681	975	11945
Interest	172	231	273	754	738	781	219	754	380	1200	610	610	6722
Foreign	58	155	97	57	630	316	41	599	260	400	340	330	3283
Domestic	114	76	176	697	108	465	178	155	120	800	270	280	3439
Other	375	418	359	256	476	420	488	344	457	370	514	322	4799
LOCAL CAPITAL INVESTMENT	4407	3586	3941	4969	4003	3012	3055	3235	3235	1477	1477	1477	37874
Donor Project Related	4042	3503	3655	4344	3479	2442	2646	2655	2455	697	797	797	31512
Local Initiative	365	83	286	625	524	570	409	580	780	780	680	680	6362
AMORTIZATION	105	1477	202	480	1240	230	237	1207	69	735	629	450	7061
IMF		1060		129	1060	129		1060		342	470	213	4463
ECCB													
Domestic	105	61	61	61	72	59	38	38	38	38	47	59	677
Other External		356	141	290	108	42	199	109	31	355	112	178	1921
RECURRENT BALANCE	843	848	952	233	-815	207	503	-5951	1523	87	-591	384	-1777
OVERALL BALANCE	-3669	-4215	-3191	-5216	-6058	-3035	-2789	-10393	-1781	-2125	-2697	-1543	-46712
FINANCING (GROSS)	5051	4030	4227	5269	4585	4760	2519	5915	2455	1439	1567	1310	43127
Of Which, Borrowing:	1433	1411	879	1522	967	2676	367	4060	600	942	1070	813	16740
IMF (Borrowing)													
ECCB (Borrowing)		1060		129	1060	129		1060		342	470	213	4463
Other External (Borrowing)	242	68	307	51	445	25	253	600	600	600	600	600	4391
Domestic (Borrowing)	1191	283	572	1342	-538	2522	114	2400					7886
BALANCE AFTER BORROWING:	-2236	-2804	-2312	-3694	-5091	-359	-2422	-6333	-1191	-1193	-1627	-730	-29972
Of Which, Grants	3618	2619	3348	3747	3618	2084	2152	1855	1855	497	497	497	26387
BAL. AFTER BORR. & GRANTS:	1382	-185	1036	53	-1473	1725	-270	-4478	674	-686	-1130	-233	-3585
Additional Repayment Obligations:	0	0	0	0	0	0	0	0	0	0	-7450	-2550	-10000
Commercial Bank Overdraft Repayment											-2800		-2800
BAL. AFTER OVERDRAFT PAID	1382	-185	1036	53	-1473	1725	-270	-4478	674	-686	-3930	-233	-6395
ECCB Repayments.											-2100		-2100
BALANCE AFTER ECCB REPAYMENT:	1382	-185	1036	53	-1473	1725	-270	-4478	674	-686	-6030	-233	-8425
Repayment of Statutory Bodies											-2550	-2550	-5100
FIN. GAP AFTER REPAY STAT. BOD.*	1382	-185	1036	53	-1473	1725	-270	-4478	674	-686	-8580	-2783	-13555
Less: Arrearages*													5000
In external contributions													4500
In other payments													500
FIN. GAP EXCLUDING ARREARAGES													-8585

* GOCD DOES NOT KEEP ACCRUAL EXPENDITURE ACCOUNTS. JULY-FEB. UNPAID VOUCHERS ARE ONLY ESTIMATES.
LARGE INCREASE IN FEBRUARY EXPENDITURES REFLECT CUMULATIVE ARREARAGES THROUGH FEBRUARY,
INCLUDING 4.5 MILLION IN EXTERNAL CONTRIBUTIONS TO ORGANIZATIONS. MARCH TO JUNE EXPENDITURES ARE ESTIMATED ACCRUALS.
THIS IS NETTED OUT AT THE END OF THE TABLE.

Table 4

Dominica Central Government Operatio
1985/86
(EC$000)

	JAN	FEB	MARCH	APRIL	MAY	JUNE	JAN-JUNE TOTAL	YEAR TOTAL
RECURRENT REVENUE (CASH BASIS)	7111	6170	8027	7228	6381	7361	42278	84055
Taxes	6229	5649	7602	6437	6042	6513	38472	75754
Direct	2044	1607	3144	2365	1749	1464	12373	24648
Indirect	4185	4042	4458	4072	4293	5049	26099	51106
Nontax Revenue	882	521	425	791	339	848	3806	8301
RECURRENT EXPENDITURE (ACCRUAL*)	6608	12121	6504	7141	6972	6977	46323	85832
Personal Emoluments	4059	4106	3860	3885	3947	3850	23707	47196
Goods and Services	1016	2193	1220	1220	1220	1220	8089	15170
Transfers	826	4724	587	466	681	975	8259	11945
Interest	219	754	380	1200	610	610	3773	6722
Foreign	41	599	260	400	340	330	1970	3283
Domestic	178	155	120	800	270	280	1803	3439
Other	488	344	457	370	514	322	2495	4799
LOCAL CAPITAL INVESTMENT	3055	3235	3235	1477	1477	1477	13956	37874
Donor Project Related	2646	2655	2455	697	797	797	10047	31512
Local Initiative	409	580	780	780	680	680	3909	6362
AMORTIZATION	237	1207	69	735	629	450	3327	7061
IMF		1060		342	470	213	2085	4463
ECCB								
Domestic	38	38	38	38	47	59	258	677
Other External	199	109	31	355	112	178	984	1921
RECURRENT BALANCE	503	-5951	1523	87	-591	384	-4045	-1777
OVERALL BALANCE	-2789	-10393	-1781	-2125	-2697	-1543	-21328	-46712
FINANCING (GROSS)	2519	5915	2455	1439	1567	1310	15205	43127
Of Which, Borrowing:	367	4060	600	942	1070	813	7852	16740
IMF(Borrowing)								
ECCB (Borrowing)		1060		342	470	213	2085	4463
Other External (Borrowing)	253	600	600	600	600	600	3253	4391
Domestic (Borrowing)	114	2400					2514	7886
BALANCE AFTER BORROWING:	-2422	-6333	-1181	-1183	-1627	-730	-13476	-29972
Of Which, Grants	2152	1855	1855	497	497	497	7353	26387
BAL. AFTER BORR. & GRANTS:	-270	-4478	674	-686	-1130	-233	-6123	-3585
Additional Repayment Obligations:	0	0	0	0	-7450	-2550	-10000	-10000
Commercial Bank Overdraft Repayment					-2800		-2800	-2800
BAL. AFTER OVERDRAFT PAID	-270	-4478	674	-686	-3930	-233	-8923	-6385
ECCB Repayments					-2100		-2100	-2100
BALANCE AFTER ECCB REPAYMENT:	-270	-4478	674	-686	-6030	-233	-11023	-8485
Repayment of Statutory Bodies					-2550	-2550	-5100	-5100
FIN. GAP AFTER REPAY STAT. BOD.*	-270	-4478	674	-686	-8580	-2783	-16123	-13585
Less: Arrearages*:							5000	5000
In external contributions							4500	4500
In other payments							500	500
FIN. GAP EXCLUDING ARREARAGES	-270	-4478	674	-686	-8580	-2783	-11123	-8585

* GOCD DOES NOT KEEP ACCRUAL EXPENDITURE ACCOUNTS. JULY-FEB. UNPAID VOUCHERS ARE ONLY ESTIMATES.
LARGE INCREASE IN FEBRUARY EXPENDITURES REFLECT CUMULATIVE ARREARAGES THROUGH FEBRUARY,
INCLUDING 4.5 MILLION IN EXTERNAL CONTRIBUTIONS TO ORGANIZATIONS. MARCH TO JUNE EXPENDITURES ARE ESTIMATED ACCRUALS.
THIS IS NETTED OUT AT THE END OF THE TABLE.

Future Financing Requirements

Program assistance will help Dominica cover its short term obligations without forcing it to resort to nonconcessional financing. Every effort should be made to assure that such financing is kept to a minimum. Prolonged resort to costly financing will place an unmanageable debt burden on government finances, will interfere with the Public Sector Investment Program, and ultimately will forestall sustained economic growth.

In the long term, further efforts must be made to improve the underlying structure of Dominica's government finances, including increasing the efficiency of the revenue collection system, maintaining restraint in government current expenditures, and increasing the elasticity of the revenue system. It is anticipated that these changes will be made under the auspices of a "Tight Consultative Group" medium-term structural adjustment program that will follow the present short term budgetary support assistance. For at least the rest of this decade, and probably for some time beyond, Dominica will require sustained and significant levels of assistance. Even with the aid of significant structural adjustment assistance, it is unlikely that the economy will generate sufficient domestic savings to fully finance its capital needs.

In fiscal 1986/87, it is probable that additional budgetary assistance will be required. The proposed second tranche of AID support funds will fill part of the need. It is anticipated that the GOCD can work out an arrangement with the Fund that will provide assistance, perhaps at concessional terms, during the 1986/87 fiscal year. Future budgetary assistance will be required from time to time until the burden of debt service payments to external lenders is reduced. It is likely that Dominica will receive $ 2 million in IDA VII funds as soon as all parties agree on a structural adjustment program for the country. Up to $20-25 million will be available to the OECS region under IDA VIII (July 1987 to June 1990), in which it is assumed that Dominica will share.

Policy Issues

The main development issues in Dominica center on the need to increase exports and to increase public sector savings. The conditions precedent and covenants for this Grant are designed to encourage the Government of Dominica to take actions to analyze and to address these issues, and which will prepare Dominica to participate in a new donor facility which is likely to be in place by Summer, of 1986.

Increasing Exports. This will involve activities and policies designed to enhance the productivity and marketability of agricultural and manufactured goods. The present constraints on exports have been discussed elsewhere in this paper.

Rationalization of the PSIP selection process. Dominica's immediate problem is one of liquidity. The longer term problem is the ability of government to foster the growth process by providing infrastructure. Increased revenues and slower growth in recurrent expenditures will partly meet this need. Donor assistance will be expected to fill much of the gap for some time to come. To supplement these efforts, it will be necessary to carefully husband the capital budget as well. Long term efficiency in the use of GOCD's limited resources and of donor-financed infrastructure will require that investment decisions be based upon a long term strategy that relates public investment to identifiable development goals. This is not to suggest the need for an elaborate planning document, but rather a strategic, rather than ad hoc approach to capital investment decisions.

The budgeting system. There are some apparent structural weaknesses, since the current and capital budgets are in effect carried out by two different agencies. The system works well now because of the close working relationship of the individuals in charge of each unit. Consideration should be given to introducing an integrated program budgeting system.

Public employee wage costs. Restraining growth in the wage bill will be necessary in order to reduce drain on current account. Government managed to reduce public employees' wage demands from a 47 percent increase in the first year to a 20 percent increase over three years. While this showed a great deal of strength on the part of the government, GOCD cannot really afford even that concession. Excessive future wage increases will place a heavy burden on government finances and will hinder its capacity to contribute to capital development. Reduction in the number of public sector employees does not seem to offer promise of significant reduction in salary costs. Of approximately 2000 civil service employees, most are police, nurses, teachers and agriculturalists. "Hard core" civil servants number perhaps 500. Given the low salaries paid to clerical workers, it would take proportionally very large reductions in staff to affect significant monetary savings. A manpower study is currently underway aimed at improving the efficiency and producticity of government employees. As part of the structural adjustment reform, the government will be expected to develop a plan of action to deal with wage costs in its recurrent budget.

Taxes and Fiscal Reforms. The present 4-level consumption tax system needs to be rationalized. One consultant has recommended someone to come in for short-term TA to examine this. So far, GOCD is not interested. The income tax should be simplified. This would yield benefits in the form of greater compliance, easier enforcement, and higher tax yields without the necessity of resorting to higher rates. The effects of the fiscal system on private incentives should be investigated, and reforms made if necessary.

Private investment and manufacturing. A World Bank official has recently visited Dominica and looked at its economy. He was most surprised by the poor performance of the manufacturing sector and by the difficulties of eliciting local and foreign private investment. RDO/C has a Project Development and Planning project (PDAP) suited to addressing this need.

Program Elements

Use of Local Currency

The Government of Dominica will use the local currency generated by this grant to maintain its activities without having to further reduce expenditures already identified under its Public Sector Investment Program. These include: Floriculture development; Tropical Treecrops and Spices; Essential Oils and Spices; Integrated Rural Development; Fisheries Development; Livestock Training Development Center; Water Development; other infrastructure projects supportive of the private sector.

Cash Transfer versus Commodity Import Program (CIP)

In designing the program, the Mission weighed the merits of a Cash Transfer versus a CIP and the experience with both in other countries in the Caribbean Basin and elsewhere. Based on an analysis of the advantages and disadvantages of both approaches, the Mission concluded that the Cash Transfer mechanism was the best means to achieve the objectives of this $2.5 million program. The problem facing Dominica is not fundamentally a shortage of foreign exchange and an inability to import commodities. It is a shortage of short term budgetary liquidity. The procedures and controls required to implement a CIP would impose a degree of public sector intervention and control over the allocation and use of foreign exchange which would be contrary to both Dominica's and USG's policy of relying on the market mechanism. The Cash Transfer approach will also require less staff time to administer, both on the part of Dominica and the Mission. The GOCD's manpower base is already stretched to the limit, and a heavy demand exists on Mission staff to implement the RDO/C assistance program.

Reports

The Grantee will be required to report on how funds have been expended in conformance with the objectives of the program. Specification of content and timing of Grantee's reporting requirements will be contained in a Project Implementation Letter. RDO/C's current thinking is that reports will be due no later than one year from the disbursement which that report covers.

Importation of U.S. Commodities

It is expected that Dominica will import commodities from the United States in value equal to or exceeding that of the Grant. Dominica's imports from the U.S. were US$ 13.3 million in 1982, 10.9 million in 1983, 14.8 million in 1984 and 13.6 million in 1985. They should therefore far exceed the requirements noted above as Condition Precedent (e).

Conditionality Under the Present Cash Transfer

The Grant will be disbursed in two tranches: $1.5 million on June 15, 1986 and $1.0 million on September 1, 1986.

Conditions Precedent to the Initial Disbursement

Prior to the disbursement under this Grant of $1,500,000, or to the issuance by A.I.D. of documentation pursuant to which disbursement will be made, the Grantee will, except as the Parties may otherwise agree in writing, furnish to A.I.D., in form and substance satisfactory to A.I.D.:

(a) An opinion of the Attorney General of the Grantee stating that this Agreement has been duly authorized and/or ratified by, or executed on behalf of, the Grantee, and that it constitutes a valid and legally binding obligation of the Grantee in accordance with all of its terms

(b) A statement representing and warranting that the named person or persons have the authority to act as the representative or representatives of the Grantee together with a specimen signature of each person certified as to its authenticity.

(c) Evidence that a special and separate local currency account has been established in Dominica into which the Eastern Caribbean (EC) dollar equivalent of the Cash Transfer Grant will be deposited.

(d) A list of domestically funded public sector development activities to be supported by the Grant and estimated amounts to be allocated to each activity.

(e) An official letter in which the Grantee agrees to (1) import from the United States goods, from those import categories previously approved by A.I.D. and furnished to the Government of the Commonwealth of Dominica, in an amount at least equivalent to disbursements under the Grant over a one year period from the date of the first disbursement hereunder; (2) monitor such imports and keep A.I.D. informed as to progress; and (3) certify and document in form and substance acceptable to A.I.D. the value of imports actually made from approved categories during a one year period from the disbursement of the Grant.

Other Conditionality

(a)Prior to the disbursement of the first tranche of $1.5 million, the Grantee will, except as the parties may otherwise agree in writing, furnish to A.I.D., in form and substance satisfactory to A.I.D., evidence that the Grantee has, in connection with the "Tight Consultative Group" process, drawn up a plan of action for developing a medium-term Structural Adjustment Program and is actively supporting that development.

(b) Prior to the disbursement of the second tranche of $1.0 million, the Grantee will, except as the parties may otherwise agree in writing, furnish to A.I.D., in form and substance satisfactory to A.I.D. evidence that the Grantee has begun an analysis of the fiscal system, including an examination of the effect of revenue measures on private sector incentive, that will be acceptable to fit into a larger structural adjustment program.

(c) Prior to the disbursement of the second tranche of $1.0 million, the Grantee will, except as the parties may otherwise agree in writing, furnish to A.I.D., in form and substance satisfactory to A.I.D. evidence that the Grantee has a study of private investment and manufacturing well in train.

Covenants

(a) The Grantee will maintain financial records, in accordance with generally accepted accounting principles, to assure compliance with the Grant Agreement, such records to be maintained for at least three years after the date of disbursement hereunder and to be made available upon request for examination at any reasonable time by authorized representatives of A.I.D.

(b) The Grantee, using the highest lawful rate of exchange existing at the date of the local currency deposit, will immediately upon disbursement of the Grant deposit the local currency into the previously established special and separate account in Dominica, in the equivalent amount of the Grant proceeds, which special account shall, except as A.I.D. may otherwise agree in writing, be established and used by the Government of Dominica to support their activities in public sector investment in mutually agreed to by A.I.D. and the Grantee.

(c) The Grantee covenants that it will give appropriate publicity to the Grant and activities funded thereunder as the program to which the United States has contributed.

(d) The Grantee shall carry out the Program or cause it to be carried out with due diligence and efficiency, in conformity with sound technical, financial and management practices, and in conformity with those documents, plans, specifications, contracts, schedules or other arrangements, and with any modifications therein, approved by A.I.D. pursuant to this agreement.

(e) The Grantee covenants to provide qualified and experienced management for, and train such staff as may be appropriate for the maintenance and operation of the Program, and, as applicable for continuing activities, cause the Program to be operated and maintained in such a manner as to assure the continuing and successful achievement of the purposes of the Program.

(f) The Grantee covenants to meet at regular intervals with A.I.D. in order to consult concerning the effectiveness undertaken through the Agreement.

ANNEX A

THE DOMINICAN ECONOMY IN THE MID-1980's

GDP Growth

After a strong recovery from hurricane damage in 1979-80, real GDP expanded at an average annual rate of 2.5 percent in 1982-83, 4.5 percent in 1984. The resource gap declined from 70.7 percent of GDP in 1980 to about 32 percent in 1984. Gross domestic savings went from a negative 21 percent of GDP to a positive 6.6 percent of GDP in 1984.

GDP statistics have not been completed for 1985, but preliminary indications are that there was a distinct slowdown that year, with growth perhaps not exceeding 2 percent. The malaise appears to be continuing into 1986, where growth could be even slower than in 1985, perhaps between zero and 2 percent. Several factors account for this slowdown. The economy started from a very low post-hurricane base in 1980. The relatively high growth rates from 1980 to 1984 were attributable in considerable measure to the large investments required for the reconstruction and rehabilitation program. Public sector investment accounted for nearly 60 percent of total investment during the period. That activity is now ending. A major road construction program, including a major AID project is nearing completion. The economic slowdown has squeezed government revenues, and its own investment program has had to be phased down for budgetary reasons. Private investment has not been forthcoming in suffient quantities to offset the decline.

Balance of Payments

There are no complete official balance of payments estimates for Dominica. Data provided in the tables were estimated by IMF officials in March 1986 on the basis of information about some external transactions compiled by Dominican officials. Data interpretation must therefore be made with this in mind.

Dominica's trade balance improved steadily each year between 1980 and 1983, but the trend temporarily reversed in 1984. The balance of trade deficit declined from nearly 74 percent of GDP in 1980 to 25 percent of GDP in 1983, before rising to 35 percent in 1984. Exports increased rapidly as production of bananas, coconuts and citrus fruits recovered from the devastation of the 1979/80 hurricanes. This was supplemented by an increase in manufactured exports, as new operations came on stream. With the establishment in 1979 of a larger soap plant, and the 1982-84 startup of several small assembly plants, manufacturing increased from 12 percent of exports in 1978 to 40 percent in 1983-84. From 1980 to 1983, imports decreased as emergency aid was phased down. But, in 1984 exports fell by 7 percent and imports increased by 18.5 percent, partly due to the import requirements of major infrastructure projects. Bananas account for over 40 percent of Dominica's exports. In 1984, the volume of exports increased from 29 thousand to 32 thousand tons. However, since bananas are contracted in sterling, the strong dollar had the effect of lowering the unit price received by 11 percent, leaving the value of shipments virtually unchanged from 1983. Exports of other agricultural crops have been stagnant since 1982. Dominica has had difficulty achieving pre-hurricane levels of citrus fruits and coconut product exports, since it finds itself in competition with producers who can achieve lower production costs because of new techniques. Fresh Vegetable and plantain exports expanded in 1983-84.

Much of the coconut output is processed into toilet and laundry soaps, which are marketed largely in Jamaica and Trinidad. Soap exports increased from 5100 tons in 1980 to 6800 tons in 1981/82. By 1984, exports had fallen to 4200 tons and the value of soap products fell by 27 percent, because of competition from Jamaican producers, and because of the sharp appreciation of the EC$, which is pegged to the U.S. dollar, vis a vis sterling and the Jamaican dollar. The establishment of a corrugated roofing sheet plant and two garment factories led to sharp increases in exports of manufactures between 1981 and 1983. The value of these exports increased from zero in 1980 to US$ 4 million in 1983. In 1984 one of the garment factories closed down, and another began experiencing difficulties in selling its output. Although 10 new assembly plants were brought into Dominica in 1985, exporters will continue to experience difficulty in the CARICOM market in the near term. After the sharp increase in 1984, the rate of increase in imports should return to its long term trend.

Dominica's tourism industry is very small. There are only about 370 rooms to accommodate visitors. Because it lacks white sand beaches, it stands as a secondary destination from other islands for persons wanting to visit its rain forests and natural areas in the interior.

Net private transfers come mainly from Dominicans living abroad, and have remained in the 9 million dollar range for several years. Official transfers declined from 18 million dollars in 1980 to only 4.4 million in 1983, before increasing sharply to 14 million in 1984. Most of the increase was associated with project-related donor grants, and official transfers are projected to diminish during the remainder of the decade.

The public sector increased its external borrowing substantially from 1982 to 1984, largely to finance infrastructure development, including roads, agricultural infrastructure and factory shells. In part as a consequence of this effort, private direct investment increased from nearly zero in 1980 to about 1.6 million in 1984. Short-term capital movements in recent years were dominated by the buildup of arrearages by Jamaican soap importers, which were repaid in 1984.

Between 1980 and the end of 1984, Dominica's external debt, including debt to the IMF, increased from $US 17 million (30 percent of GDP) to $US 43.2 million (50.5 percent of GDP). Net purchases under IMF facilities accounted for nearly one third of this increase. CDB accounted for another 11 million, IDA 3 million, IFAD 1 million and OPEC 2 million. Except for that due to the Fund, most of this debt is on highly concessional terms, with interest rates of under 4 percent, grace periods of 5 years, and repayments of 15 to 20 years. The terms of the Fund debt have been the main reason for an increase in the debt service ratio from 4 percent in 1980 to 12.5 percent in 1984. Government has serviced its Fund debt on a timely basis and has not incurred any additional Fund obligations since the 1984/85 Standby.

Debt service absorbs increasing portions of both export earnings and of the public budget. Interest and amortization payments are equivalent to 20 percent of government's recurrent revenues. With a shortfall in resources to make repurchases from the IMF, government will be faced with the prospect of increasing its nonconcessional borrowing from other sources in order to finance the Fund obligations. Borrowing at nonconcessional terms will increase the debt servicing significantly, and may eventually be harmful to GOCD's credit standing in the international community. Government is obviously anxious to avoid this eventuality. In the short term, debt servicing will impose a cash flow problem, which can be eased by budget support. Long-term health of the public finances, however, will depend upon the ability of the government to foster sustainable export-led economic growth.

Exchange Rate

Dominica's currency is the Eastern Caribbean (EC) Dollar, which is also used by the other OECS countries. The EC dollar is pegged to the U.S. dollar at a rate of 2.7 EC dollars to one U.S. dollar. The official exchange rate can be changed only by a unanimous vote of the OECS countries. The Real Effective Exchange Rate (REER) for a given state does change as the value of the U.S. dollar vis a vis other currencies changes, and as inflation rates among trading partners vary. The extent to which the effective exchange rates among OECS states vary will therefore depend upon the commodity mix of each country's exports, and the relative importance of different trading partners in their overall trade.

Since 1980, Dominica's real effective exchange rate appreciated by from 10 to 20 percent, depending upon which weights are used in making the calculations. Compared to other OECS States, Dominica engages in proportionally more trade with the U.K and has a larger trade with Trinidad and Jamaica. Thus, the REER appreciation is due largely to the appreciation of the U.S dollar against sterling. When the December, 1985 devaluation of the Trinidad dollar is added to that, the overall appreciation is greater than for any other OECS state except Grenada.

Appreciation in Dominica has been almost continuous since 1976, with the exception of 1985. The U.S. dollar depreciation in 1985 caused the REER for Dominica to depreciate by 13.6 percent, but this was partially offset by devaluation in Trinidad. The latter, combined with the U.S. dollar effect, yielded a net 7.3 percent depreciation for Dominica in 1985. Thus, some improvement has occurred and more can be expected as the U.S. dollar depreciates further. A further 10 percent depreciation of the U.S. dollar will virtually remove any overall appreciation for Dominica, despite the heavy trade weight accorded to the U.K.

Dominica's main export markets are in the U.K., Trinidad and Jamaica. Exports are thus severely hurt by the economic crises that have developed in the latter two countries. This is not offset by nonfactor service earnings, since Dominica's tourist trade is the smallest in the OECS except for Montserrat.

On the other hand, Dominica may benefit as the U.S. dollar weakens. Banana quotas are sold in sterling. As sterling gains against the dollar, the dollar value of bananas should move toward previous levels, reversing the events of the past few years. About one fourth of Dominica's imports are from the U.S. As the dollar weakens, there should therefore be only moderate increases in import prices. Thus wage demands that are often associated with increased costs of imports may not be as great as they would otherwise be.

Trade with Jamaica and Trinidad, and probably with the rest of CARICOM, will continue to be a problem. Dominica is hurt more by the quantitaive restrictions in both places than be any adverse price relationships. Both Jamaica and Trinidad have been high-inflation countries and their recent devaluations have been attempts to bring their price structures back into line with the rest of the world. Indeed, their devaluations bring the real exchange rate between themselves and Dominica back to where it was just a few years ago. Quantitative restrictions imposed by these two countries were imposed as their exchange rate situation worsened before devaluation. In the case of Jamaica, it is expected that these controls will remain in effect, since that country still does not have its exchange rate under control. In the case of Trinidad, it is too early to tell, but experience suggests that their restrictions will be eased only gradually, if at all.

Despite these problems, Dominica's balance of payments seems to be improving since the hurricanes of 1980. Following that, exports were down, and reconstruction led to sizeable imports. Except for 1984, the current account has improved since then. In 1984, a road rehabilitation program caused a notable, though temporary, increase in imports, financed mostly with official transfers. Projections by the IMF indicate a current account balance declining from 9 percent of GDP in 1984 to 4 percent in the late 1980's.

While Dominica would benefit from further depreciation of its effective exchange rate, unilateral alteration of the exchange rate is not a policy option. An across-the board devaluation of the EC dollar is neither possible nor desirable at this time. It is not desirable, because only Grenada and Dominica have experienced significant appreciation in recent years, and there is little reason to believe that the EC dollar is generally overvalued. In the case of Antigua, there are suggestions that it is undervalued. It would therefore be impossible for Dominica to muster the votes necessary to revalue the EC dollar, even if it chose to do so. Relief will come in the short run if the U.S. dollar continues to fall. In the medium to long term, increased capability to export a variety of products outside the region would reduce Dominica's dependence on Jamaican and Trinidadian trade, and should help restore a real effective exchange rate that is consistent with sustainable high levels of exports.

The most effective means of improving Dominica's balance of payments performance therefore lies not in exchange rate manipulation, but in efforts that will directly encourage exports, and discourage nonessential imports. Improved efficiency in production and marketing of traditional agricultural crops, and introduction of new agricultural and manufactured exportable commodities should help improve Dominica's trade balance in the coming years. External support will be needed in the short run to assist Dominica through the period required for the current account to improve.

Agriculture

In agriculture, production still has not reached pre hurricane levels. Bananas are the major export crop but production is still recovering from the adverse effects of the 1979-80 hurricanes and the relative depreciation of the pound sterling against the U.S. dollar. The latter was responsible for a 7 percent reduction in the price paid to growers between 1980 and 1984. Government had targeted production at 40,000 tons by 1985, but only 33,000 tons were forthcoming. In 1984, while bananas accounted for almost 20 percent of the value of agricultural production, their value was was still 23 percent below its 1978 level. The Dominica Banana Marketing Corporation is encouraging measures to increase productivity. The marketing aspect of the banana industry has been substantially restructured. Field packing accounted for 20 percent of banana exports in 1982, 50 percent in 1984, and is targeted to reach 90 percent by the end of 1986. These and other improvements helped to increase the grower's price as a proportion of export price from 39.5 percent in 1982 to 46 percent in 1984. Coconuts are the basic input into Dominica's soap industry. By 1983, an extensive replanting program had brought coconut output back to 85 percent of 1978 levels. In 1984, a downturn in the fortunes of the soap industry reduced the demand for coconuts by 6 percent. While the rehabilitation program continues, market prospects are limited by developments elsewhere in the region. Dominica is moving to diversify its agriculture into citrus fruits, and the first harvesting of Arabica coffee has begun. Government divestiture of farm lands is proceding and efforts are beginning to bring more land under cultivation.

Manufacturing

Although entrepreneurs are given generous fiscal incentives, and factory shells have been constructed to lure foreign enclave industries manufacturing output has slowed. After increasing rapidly until 1982, manufacturing output grew at only 2 percent in 1983 and declined by 1 percent in 1984. This is accounted for to some extent to the decrease in exports of coconut products, including soap, which faced tough competition from Jamaica and which suffered from the appreciation of the EC dollar vis a vis the Jamaican and Trinidadian currencies. In 1983-84, the adverse developments in coconut related industry were partly offset by the initiation of several new industries, including a galvanized steel operation, garment manufacturing, and several other operations. However, since then a refrigerator assembly operation has shut down, two garment manufacturers have closed town, and the output of the galvanized steel plant has been reduced by 90 percent.

Tourism

Tourism, never a major industry, will probaby continue to show little, if any, growth in the near term. Dominica lacks white sand beaches, and has very limited accommodation facilities. For the time being, the sector will rely on its role as a secondary destination for tourists from other islands who wish to enjoy the natural attractions of the rain forests in the interior. While19here is some room for expansion, tourism will contribute relatively little to the economy in the forseeable future.

The best growth prospects in the near term are to be found in revitalizing agriculture and in regaining lost investments in light manufacturing. Industries were initially attracted to Dominica by low wages, generous fiscal incentives and a stable political environment. The recent plant closures have introduced an element of uncertainty into the picture which must be counteracted if foreign investment is to again be attracted to Dominican industry.

Government Finances

When the current government took office in 1980, it faced a situation in which the recent loss of U.K. budgetary support, a previous excessive public employee wage increase, and the revenue loss and expenditure demands imposed by three hurricanes, had combined to create severe budgetary strains. The government approached the IMF and negotiated a three-year Extended Fund Facility. Under that program, the government broadened the revenue base, raised taxes and strengthened the revenue collection mechanism, while pursuing a policy of expenditure restraint. As a result, the Central Government's current account deficit declined from EC$17 million (10 percent of GDP) in 1980/81 to near balance in 1983/84. In addition, improved management of public enterprises has virtually eliminated their previously heavy demands on the public budget. Those entities now require virtually no transfers from Central Government. In spite of these changes, deficits had not yet turned into surpluses, and government had no resources to contribute to a capital program. In 1983/84 Dominica received $US 2 million in program support, the local proceeds of which were applied to capital projects.

The following year, the government's current account balance continued to improve, but its financing requirements increased further as IMF repayments became due. Dominica then entered into a standby arrangement with the Fund for SDR1.4 million for 1984/85.

Dominica's performance under both IMF arrangements was good. Payments were on time, and agreed-upon reform measures were undertaken. Under the 1983/84 program, government was unable to draw its April quota because it exceeded the programmed ceiling on nonconcessionary borrowing. This occurred first because an unseasonable spring storm required emergency spending and second because of substantial tax refunds that the government wanted to make before the end of the fiscal year, which had an unintended effect on nonconcessional borrowing. By September, they were back on stream and were able to draw the remaining balance of the EFF. The 1984/85 standby had to be suspended in February of 1985. On that occasion bad weather made it necessary to spend one million dollars EC to restore damaged communications. Failure to reach agreement on what the government felt to be excessively costly conditionality led to suspension, after approximately 1.1 million of 1.4 million SDR's had been drawn. The current account continued to improve, and showed a small surplus in 1984/85.

Prices and Wages

Inflation, as measured by the Consumer Price index, has moderated each year since 1980. In that year, prices increased at an annual rate of 30.5 percent. In 1981, the rate had fallen to 13.3 percent, and dropped to a little over 4 percent in 1982 and 1983. Since then, inflation rates have been around 2 percent. The main contributing factors to these changes were: import prices, which increased slowly in 1981 and declined from 1982 to 1984; a marked slowing in the increase in wages; and larger food supplies.

Fifty-five imported items, mostly food and construction items, are subject to maximum markups of 8 percent at wholesale and 12 percent at retail. Utility and petroleum product prices are regulated. While such controls are not pervasive, in its policy dialogue RDO/C will encourage critical review of those that exist and removal of those which are significant impediments to efficient economic performance. It is assumed that these will also undergo careful scrutiny in preparing a structural adjustment program.

The government of Prime Minister Charles has made substantial progress in moderating wage demands. Early in her administration, the PM took steps to sever the automatic link that existed between inflation and civil servants' wage increases. She agreed to pay wage arrearages that had resulted from the the pay accord negotiated by the previous government. In return, the Civil Servant's Association agreed to settle for 10 percent annual wage increases during the 1982-84 period. Wages in the private sector have been held below that 10 percent ceiling, but have been influenced by public sector wage settlements. Even the 10 percent ceiling was considerably higher than the rate of inflation over the same period. Wage costs are still a major source of difficulty in the government's ability to control its finances. Despite improved labor relations in recent years, government was faced with a potentially damanging public employees strike and in December settled a wage agreement in excess of 20 percent over three years. While both government and outside observers are concerned about this, it did represent a considerable improvement over the 47 percent in one year originally demanded by the employees.

The government of Dominica is continuing efforts to improve the performance of the public sector. It is obtaining technical assistance from the Interagency Resident Advisory Mission (IARM) for an operation and management study of the public sector as a whole. It is expected that the findings of the study will recommend changes that will lead to more efficient use of human resources and increase public sector productivity.

ANNEX B

AID'S PARTICIPATION IN THE "TIGHT CONSULTATIVE GROUP"

Early in 1986 the OECS Economic Affairs Secretariat, with country assistance, developed a proposal for an "Eastern Caribbean Development Facility." The ECDF was designed around the concept that the OECS states would engage in codified structural adjustment programs in return for budgetary support from the donors. However, because the majority of donors either could not provide budgetary support (by their own laws) or could not participate in such a pooling of program assistance (by their charters), the ECDF was declared unworkable at March 1986 Caribbean Group meetings in St. Lucia and an alternative, the "tight consultative group" (TCG) concept, was tabled by the World Bank.

At the March 1986 meetings the US delegation, under instructions from Washington, endorsed the TCG concept. Within RDO/C, we intend to use the resources planned under the "Structural Adjustment Support Program" (SASP) for FY87 and FY88 and beyond to support the TCG approach. The Mission plans to have in AID/W for review in July 1986 a concept paper for the SASP. The current program for Dominica is meant to fill the fiscal gap so that the GOCD can remain solvent until the TCG concept comes on stream for them early in 1987.

The TCG concept is still evolving, but it holds promise as an effective means of focusing program and project assistance on structural adjustment problems in the OECS. The focusing of resources should greatly enhance the efficiency of their use in bringing about structural adjustment. Our current understanding of the TCG concept, and what appears to be its composition, is set out below.

(A) Tight Consultative Group Approach. CGCED donors and recipients have agreed, in principle, on a "tight consultative group" approach to coordinating structural adjustment programs in OECS states. For OECS countries interested in embarking on structural adjustment programs that make use of the IMF and World Bank program assistance, the TCG would likely replace the CGCED subgroup meetings held heretofore. The TCG is envisioned as a "tight" group in that participating donors would be limited to those that are actively and financially contributing to the structural adjustment program in the OECS state in question. In addition to the IMF and itself, the World Bank expects the US (as the only other donor able to provide program assistance) to participate in and be guided by the TCG in its decisions on not only program assistance but also project assistance to the OECS state in question. The World Bank also is looking forward to the participation in the TCG by those bilateral donors who expressed their inability to participate in the program assistance inherent in the Eastern Caribbean Development Facility (ECDF), but who said that they would strongly support structural adjustment efforts in the OECS in any other way they could. The TCG approach promises to better focus external assistance to the OECS states, although it also potentially entails something of a loss of flexibility in deciding what projects to either continue or initiate.

(B) Medium-term Structural Adjustment Programs. In order to gain and maintain access to the resources available under the TCG approach, a country will have to agree to a medium-term (three-year) structural adjustment program. The MTSAP, as presently envisioned, will contain relatively clear-cut targets for the ensuing year and less clearly defined ones for remaining years in the program. The IMF, World Bank, and the recipient country--and presumably other donors participating in the TCG--will all have to agree on the program. The World Bank has offered to assist any country that so wishes to design the MTSAP. In the case of Dominica, the World Bank and the IMF will field a joint team (in early May) to begin working on that program.

(C) Structural Adjustment Facility. IMF has decided to make trust fund reflows (about USDOLS 2.7 billion) available to IDA-eligible LDCs worldwide on very concessional terms in a "Structural Adjustment Facility" (SAF). Funds equivalent to 20 percent of (IMF) quota would be available in the first year, with 13.5 percent in each of two subsequent years. (Dominica, with an SDR 4 million quota, would have access to SDR 800,000 the first year for a total of nearly SDR 2 million.) The funds would be loaned at 0.5 percent interest, with 5-year grace periods and another 5 years to repay. Access by a given country to its share of the funds would be contingent on IMF and World Bank determination that that country has a "sound macroeconomic framework" in place and on that country's having agreed with the World Bank and the IMF on a medium-term (three-year) structural adjustment program. Performance targets would be more like World Bank targets than the strict quantitative targets imposed by the IMF in its normal stabilization facilities. IMF Board approved the SAF program in late March 1986.

(D) IDA VIII Program Assistance. World Bank has decided, pending Board approval and pending the reinstatement of OECS countries as IDA-eligible, to make that amount of IDA VIII that will go to the OECS countries available for program (as opposed to project) assistance. According to rough estimates, that might amount to $20-25 million over the IDA VIII period (July 1987-June 1990). As part of the impending OECS "graduation" from IDA, these funds would not be solely IDA, but would be mixed with regular IBRD resources, thus implying loan terms somewhat less concessional than those under the IMF SAF program. Again, access to these resources by any country would be contingent on IMF and World Bank determination that that country has a "sound macroeconomic framework" in place and on that country's having agreed with the World Bank and the IMF on a medium-term (three-year) structural adjustment program. As an interim experiment, the World Bank has indicated to Dominica its willingness to take $2 million of the World Bank's $5 million IDA contribution to the Dominica hydroelectric project and apply it to Dominica as program assistance. The $2 million is from IDA VII and would be available as soon as all parties agree on a structural adjustment program for Dominica.

(E) Donor participation in program analysis and design. The World Bank has suggested that interested donors may wish to participate in the analysis and design work on the MTSAP. The World Bank's current thinking on this involvement is to have donors participate in the analysis of the public sector investment program (PSIP), with
interested donors carrying out analysis in their particular sector of

interest and expertise. In the Dominica case, the IBRD will upon arrival in Dominica ask the GOCD whether they would object to donor participation in the analysis phase.

According to World Bank officials, the World Bank is tentatively thinking of the following order of implementation of the TCG concept: Dominica, St. Vincent, St. Lucia, Antigua, and St. Kitts. The World Bank has not yet decided where Grenada would appear on this list. The list is based upon dealing with "easier" cases first. The World Bank has indicated that between now and the end of this calendar year they will be able to design MTSAPs for only two states. Next year, another two (or perhaps three) would be done.

Based upon our most recent conversations with World Bank officials, the World Bank will arrive in Dominica the first or second week of May 1986 and will spend several days negotiating with the Government what a schedule should be. When agreement is reached, the IMF will arrive, as will analysts provided by other interested donors (providing the Government approves this involvement.) This analysis and design phase will take several weeks. The World Bank hopes to have a paper agreeable to all involved ready to present to a TCG on Dominica, to be held in conjunction with the January 1987 Caribbean Group meetings in Washington.

RDO/C has its own policy agenda in Dominica, and that agenda will guide our assistance under this and any other program assistance provided that Government. However, RDO/C is eager not to have any conflicts between the conditionality we propose under the program assistance that is the subject of this paper and program assistance that flows out of the TCG approach, and we intend therefore to continue to maintain close contacts with the World Bank and the IMF during our period of negotiation with the GOCD. We do not foresee problems, but want to ensure that none develop. As a consequence of accidents of timing and because the funds under this program assistance are urgently needed in Dominica, RDO/C expects that conditionality negotiations will continue up to the signing of the Grant Agreement. RDO/C will maintain frequent contact with relevant AID/W parties to ensure that we all have a common understanding of the conditionality that evolves into that in the Grant Agreement.