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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/17

3:00 p.m., January 27, 1984

J. de Larosière, Chairman
W. B. Dale, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	J. K. Orleans-Lindsay, Temporary
	H. G. Schneider
	X. Blandin
	J. Delgadillo, Temporary
R. D. Erb	D. C. Templeman, Temporary
M. Finaish	T. Alhaimus
	S. R. Abiad, Temporary
T. Hirao	T. Yamashita
J. E. Ismael	Jaafar A.
	L. Leonard
	D. I. S. Shaw, Temporary
A. Kafka	C. Robalino
	G. Grosche
G. Lovato	
R. N. Malhotra	A. S. Jayawardena
Y. A. Nimatallah	J. E. Suraisry
J. J. Polak	T. de Vries
A. R. G. Prowse	K. G. Morrell
	O. Kabbaj
	M. Camara, Temporary
M. A. Senior	J. L. Feito
J. Tvedt	A. Lindø
	T. A. Clark
Zhang Z.	Wang E.

L. Van Houtven, Secretary
R. S. Laurent, Assistant

Also Present

African Department: E. Sacerdoti. Asian Department: Tun Thin, Director; U. Baumgartner, B. Smith. European Department: L. A. Whittome, Counsellor and Director; P. Dhonte, D. Gros, A. Leipold, A. M. Mansoor, L. L. Perez, E. Spitaeller, K. A. Swiderski, T. M. Ter-Minassian. Exchange and Trade Relations Department: D. K. Palmer, Associate Director; W. A. Beveridge, Deputy Director; S. Mookerjee, Deputy Director; J. A. Clement, H. W. Gerhard, M. R. Kelly. Fiscal Affairs Department: R. A. Feldman, P. S. Heller. Legal Department: G. P. Nicoletopoulos, Director; J. G. Evans, Jr., Deputy General Counsel; A. O. Liuksila, S. A. Silard. Middle Eastern Department: A. S. Shaalan, Director; F. Drees, S. Takagi. Research Department: T. Gudac. Secretary's Department: J. W. Lang, Jr., Deputy Secretary; M. Chamberlain. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer; A. G. Chandavarkar, O. Roncesvalles. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; J. A. Buyse, T. M. Reichmann. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: A. A. Agah, H. A. Arias, C. J. Batliwalla, S. El-Khouri, L. Ionescu, W. Moerke, G. E. L. Nguyen, Y. Okubo, I. R. Panday. Assistants to Executive Directors: J. R. N. Almeida, I. Angeloni, R. Bernardo, J. Bulloch, M. B. Chatah, M. Eran, G. Ercel, I. Fridriksson, G. Gomel, V. Govindarajan, D. Hammann, N. U. Haque, C. M. Hull, A. K. Juusela, H. Kobayashi, M. J. Kooymans, G. W. K. Pickering, E. Portas, T. Ramtoolah, M. Rasyid, J. Reddy, D. Robinson, A. A. Scholten, Shao Z., Wang C. Y., A. Yasseri.

1. EIGHTH GENERAL REVIEW OF QUOTAS - EXTENSION OF PERIOD FOR CONSENT

The Executive Directors considered a possible extension of the period for consent by countries to the Eighth General Review of Quotas.

Mr. Finaish commented that it would be useful to allow all countries to consent to their quota increases and to make sure that no country would be harmed by the absence of an agreement on an extension. The three countries that had not yet completed the procedures for consent would find an extension helpful.

Mr. Kabbaj associated himself with Mr. Finaish's remarks. He had just had a telephone conversation with Mr. Salehkhou, who had explained that, in the Islamic Republic of Iran, legislative approval was carried out in two stages, the first by Parliament and the second by the Council of Guardians. Mr. Salehkhou was in Iran to help with the official and parliamentary processes.

Mr. Leonard said that he would appreciate deferring a decision until the following Monday (1/30/84). It would be useful to know how long the countries that had not yet consented to the quota increase would take to agree to it.

The Secretary recalled that, at the time of the Seventh General Review of Quotas, four extensions had been granted after the effective date for consent. At the time of the Sixth Review, three extensions had been granted, the last two of nearly two months each. At the time of the Fifth General Review of Quotas, there had been two extensions. At the time of the Fourth General Review, there had been one extension of four months, one of a year, and another of six months.

Mr. Nimatallah commented that, in view of the precedent cited by the Secretary, there was no harm in extending the period for consent by one more month.

Mr. Malhotra remarked that the general approach in the past appeared to have been to give as much opportunity as possible to members to overcome any internal procedural problems with regard to consent. He strongly urged that the requests of Directors who wished an extension should be agreed to. A two-month extension might be preferable.

Mr. Schneider said that he would be able to support an extension. After all, the period from the resolution to the deadline for consent to the Eighth General Review had been extremely short compared with former general reviews of quotas.

Mr. Grosche commented that Executive Directors should bear in mind that they had agreed to complete the Eighth General Review as soon as possible owing to the special circumstances being experienced by the Fund. Some governments had taken great pains to obtain the consent of their legislative bodies in time by November 30, 1983. In extending the period for consent, the Board might make it more difficult to exert the pressure needed in such special circumstances in the future.

Mr. Robalino expressed support for an extension of the period for consent.

Mr. Prowse asked the Executive Directors concerned to specify whether the extension was being sought in an unspecific hope that agreement could be obtained, or whether an extension was being sought when processes were already under way with the expectation that consent would be forthcoming.

Mr. Finaish noted that, if Executive Directors requested an extension, the Board should have a reasonable belief that there were reasons for the request. If Directors were sure that countries would not consent, they would not ask for an extension.

Mr. Kabbaj expressed a preference for a two-month extension. As for legislative procedures, it would not be proper for the Fund to say beforehand that a national parliament would approve any measure in a specified period of time. It was a question of sovereignty and sensitivity.

Mr. Clark agreed with the point raised by Mr. Grosche.

Mr. Polak said that he had no objection to a reasonable extension; however, the Executive Board had not conducted itself in a particularly elegant fashion at the time of the Seventh General Review by extending the period for consent four times. He would agree to an extension on the present occasion, with the understanding that it would be the last one. After it expired, countries that had not yet consented might be sympathetically considered for a special quota increase, but the Eighth General Review would be closed.

Mr. Senior expressed support for Mr. Polak's view.

Mr. Grosche also expressed support for Mr. Polak's view and proposed a one-month, once-and-for-all extension.

Mr. Malhotra recalled that, in the case of his own country, special efforts had been made to accelerate an early agreement and consent. He was, however, not in favor of a stipulation that the proposed extension would be the last. He did not think that the Fund's credibility would be at stake if it extended the period for consent again.

Mr. Shaw supported Mr. Polak's suggestion. Perhaps the countries that had not yet consented could be polled to determine the best period for extension, which ought to be the last one.

Mr. Finaish observed that, as a matter of principle, there was no reason for the Board to declare that the extension being granted would be the last one.

Mr. Delgadillo stated that there was no legal limit governing the time of the extension, so that he was willing to support Mr. Finaish and Mr. Kabbaj.

The Chairman, responding to a question by Mr. Nimatallah, explained that the Eighth General Review of Quotas had already become operative in the Fund. The sole remaining difficulty was in the final distribution of votes, because countries that had not yet assented to the increase in quotas would receive no extra votes and thus would see their voting power represent a smaller proportion of total votes.

The Director of the Legal Department added that the amounts involved were very small, as was the effect on the distribution of voting power. The failure by a few countries to consent to the quota increase meant that those countries had not yet participated fully in the amount of quotas that they could obtain in the Fund.

Mr. Nimatallah said that he had no objection to making the proposed extension a final one, but it should be longer than 30 days, perhaps 45 days.

Mr. Grosche commented that, if it was so easy to obtain extensions, why should a national administration at a time of future quota increases push the legislative body to obtain assent? If every national administration could expect extensions in the period for consent from the Fund, the next quota increase might well not receive the 70 percent of votes required to make the quota increase effective.

Mr. Erb observed that his country had benefited from extensions. However, extensions granted too readily and for too long a period could be a cause for regret during the next quota increase. His authorities had placed great emphasis on the November 30, 1983 deadline for consent to the Eighth General Review of Quotas. They had been concerned not that the Fund might lose its credibility but rather that they might lose theirs by having attached so much importance to the November 30 date. Nonetheless, should the Board decide to grant another extension, he could go along with it.

The Secretary, in response to a question by Mr. Malhotra, explained that he was not aware that the Executive Board in the past had agreed to grant no further extensions to periods of consent for quota increase. To adopt what might be called a final extension was, in law, never final per se. The Board could always review a decision that it had previously taken. Identifying an extension as "final" would mean no more than an expressed intent on the part of the Executive Board.

The Director of the Legal Department recalled that, at the time of consent by countries to the Seventh General Review of Quotas, the Executive Board, in granting the last extension, had said that it would give sympathetic consideration to a country that might be unable to give consent during the required period, meaning that there would be consideration of a special quota increase for such a country. The Secretary had correctly stated that adopting what could be called a final extension was not a binding undertaking but was merely a declaration on the part of the Board.

Mr. Lovato said that he could go along with extending the period for consent, with an understanding that the countries would do their best to transmit their consents.

Mr. Hirao remarked that he had sympathy for the proposed delay, so long as the extension was for a reasonable period.

Mr. Senior, Mr. Zhang, Mr. Grosche, Mr. Shaw, and Mr. Clark agreed to an extension of 45 days.

The Executive Board then took the following decision:

The period for consent to increases in quotas under the Resolution of the Board of Governors for the Eighth General Review of Quotas is extended to March 15, 1984, at 6:00 p.m. Washington time.

Decision No. 7614-(84/17), adopted
January 27, 1984

2. INDIA - 1984 ARTICLE IV CONSULTATION, AND REVIEW UNDER EXTENDED ARRANGEMENT

The Executive Directors continued from the previous meeting (EBM/84/16, 1/27/84) their consideration of the staff report for the 1984 Article IV consultation with India, together with a proposed decision concluding the 1984 Article XIV consultation (EBS/83/276, 12/30/83; and Sup. 1, 1/26/84). They also had before them a report on recent economic developments in India (SM/84/15, 1/13/84).

The staff representative from the Asian Department, responding to questions raised by Executive Directors at the previous meeting, observed that the nominal effective exchange rate of the rupee had depreciated by about 2.3 percent from April to November 1983. During the same period, relative price movements in partner countries had been higher than those in India by about 5.3 percent in seasonally adjusted terms. As a result, the real effective rate of the rupee had appreciated by 3 percent on a seasonally adjusted basis; in November 1983, the rate had been some 4.7 percent higher than at the beginning of the program period in November 1981.

Clearly, the authorities had experienced some difficulty in implementing exchange rate policy, the staff representative continued. As in many other countries, fluctuations and unexpected movements in international exchange rates had been a factor, but, perhaps more important, uncertainty about price movements had created real difficulties for the authorities. Their expectations about price movements had developed somewhat more slowly than had events. For instance, the rate of inflation in India had turned out to be somewhat higher than expected, while the world at large had been more successful than expected in bringing down inflation. Recently, the authorities had taken a more positive approach to exchange rate management; during December and early January, the exchange rate had depreciated by about 2 percent in nominal effective terms. The movement was clearly in the right direction, although it would probably leave the exchange rate higher in seasonally adjusted terms than at the beginning of the extended arrangement.

As to the views of the staff on exchange rate policy, the staff representative continued, the original letter of intent had stated: "The Government intends to follow a realistic policy, keeping in mind, inter alia, their objectives in regard to overall balance of payments and export promotion." More recently, the staff had noted that, while important measures intended to stimulate export development had already been implemented in the program period, such measures should be strengthened. The recent adjustment of the exchange rate had been salutary, but further adjustments would be required if exports were to reach the targets for 1984/85 and for the medium term. Although exchange rate policy was an important element, it was by no means the only one. For instance, another way in which the Indian authorities could meet their objectives regarding the balance of payments and exports was by promoting import liberalization and other measures to improve efficiency.

Several Executive Directors had suggested that there had been little progress in opening up the economy, the staff representative recalled. It was wise to be careful in trying to discover from any particular set of statistics whether the economy had become more open or less open than a few years previously. For instance, total imports into India had not grown rapidly. However, imports of petroleum had declined substantially in volume terms, by 17 percent in 1981/82, by 13 percent in 1982/83, and by a further 15 percent in 1983/84. By increasing its own production, India had also succeeded in importing less steel and fertilizer. In contrast, the main imports covered by the import restriction system had risen in volume terms by 4 percent in 1981/82, by 6 percent in 1982/83, and by a projected 11 percent in 1983/84. Those increases pointed to some progress in opening up the economy. Again, export performance had been less favorable than the staff had hoped, but India had been attempting to promote a program of export development in the face of adverse circumstances in the world economy.

India's 1983/84 import policies had been implemented much as the staff had foreseen, the staff representative said. They had however been less effective than expected, partly because of the conditions of domestic demand. The import liberalization measures introduced in 1983/84 had been somewhat less significant than they had at first appeared. The Indian import system was complex, and measurement techniques were by no means precise.

A further question had been to what extent liberalization and other structural measures had improved the efficiency and productivity of the Indian economy, the staff representative went on. Although he was unaware of any direct measure of productivity or efficiency, there were different ways of examining the question. For example, Indian producers of fine leather goods were no longer frustrated in achieving their production plans by the lack of small imported fasteners. In earlier days, when imported fasteners had been scarce, Indian producers had often had to make do with a domestic substitute of inferior quality, which had down-graded the quality of their goods. At present, there were no effective restrictions on such imports, and restrictions had been lifted for a whole range of other items. Expanded access to foreign technology was also yielding benefits. For example, the public had been given a preview of a new Indian automobile made with foreign collaboration. To all observers, the new automobile represented a technical advance of several generations compared with the sturdy but technologically obsolete products produced by the domestic automobile industry. Furthermore, consumers of industrial goods were beginning to demand more in terms of quality and reliability from domestic products. The staff believed that more should be done to promote quality.

From a macroeconomic point of view, the staff representative went on, it was difficult to identify areas in which great progress had been made in increasing efficiency and productivity; despite an increase in the ratio of investment to GDP, the growth rate of the industrial sector had not shifted upward in recent years. There were no convincing indications that the private sector had become better able to confront competition from abroad. In the public sector, which accounted for 50 percent of investment, more success had been achieved in increasing the rate of investment than in improving efficiency and productivity. The authorities had been less successful in reorienting the sectoral pattern of investment to sectors that were important to the adjustment effort. Financing problems in the states were partly responsible. Mr. Ismael had also pointed to the change in capacity utilization in certain areas, especially the generation of electricity, which had been low and had fallen further. Although there were definite signs of movement in the right direction, the changes introduced so far had not reached the critical mass necessary to shift the whole economy upward.

There were two ways in which to bring about the needed structural changes, the staff representative considered: policies could either be abruptly shifted by the imposition of sweeping reforms or be slowly adapted on a piece-by-piece basis. There was no national consensus in India for an abrupt change of direction. However, the strong leadership being shown by the authorities in economic management was reflected in the steady changes that had been continuing to take place. He saw no alternative to the gradual approach, but the pace of change could appear different from different perspectives. Indians to whom he had spoken had marveled at what they considered fundamental policy changes in the direction that the Fund was recommending.

In conclusion, the authorities should persist in their efforts to improve efficiency by strengthening their pricing, industrial, and import policies, the staff representative from the Asian Department said. There might be danger in proceeding too slowly. The best justification for continuing to take strong policy measures was that those measures already taken had been yielding positive results. Otherwise, it might become increasingly difficult to sustain the momentum of structural policy change.

Mr. Malhotra recalled that Mr. Clark and Mr. Tvedt had asked why the Indian authorities wished to terminate the extended arrangement with the Fund. As he understood it, the authorities' view was that, since they could manage on their own in 1984/85, there would be distinct advantages in formally terminating the arrangement. Such a cancellation would release resources to the Fund, which could then plan its future financing of other countries' adjustment efforts with confidence. The authorities would, nonetheless, continue to pursue the needed adjustment. For instance, they had recently taken new measures to cut expenditures in order to contain inflation, even though the measures could imply an element of disruption in spending.

Some concern about the fiscal sector had been expressed on the basis of the tentative study done by the staff on structural deficits, as well as the increase in the overall central budget deficit as defined by the Fund, Mr. Malhotra remarked. While many Directors had suggested that investment in power, railroads, and coal should have been larger, others had wondered whether the public sector was taking too great a share of national savings. However, as Mr. Robalino had said, the major expansion in the budget was due to developmental expenditures within the Five-Year Plan, which emphasized investment in the sectors that Executive Directors had identified as crucial. There was a close link between budget-financed infrastructure and the overall health of the economy. Private investment could not continue to be efficient unless the public sector made enough investment in crucial infrastructural areas. The effort to expand public savings to finance such investment had been very successful; one or two Executive Directors had even said that public savings had perhaps become too large and that more should be left in private hands.

Bank deposits had been growing in a healthy fashion, Mr. Malhotra continued. Indeed, there had been some concern that they had been growing too rapidly and that the Reserve Bank of India could have immobilized a larger part thereof. The capital market too had expanded strongly, so that industries had been able to go direct to the market to raise equity or debenture capital. Thus, the crowding-out argument did not apply to the Indian situation.

The deficit of the Central Government had increased because nonbank borrowing, essentially in the form of small savings, had been higher than expected, and because oil sector deposits had expanded the pool of money available to the Government, Mr. Malhotra continued. The better small savings performance had mainly helped the states, which received two thirds of the net receipts, and that was a source of satisfaction. Regarding the oil sector surpluses, the Government had preferred that they should be used as deposits rather than appropriated as tax revenue. The Government wished to continue efforts at expanding the oil sector and the preferred arrangement would make for greater flexibility in providing money to the sector.

As for finances of states, Mr. Malhotra said, the states had made a large effort to mobilize additional resources. However, it had not always been easy for them to pass through the effects of upstream increases in prices. Further, the upsurge in inflation in the first two years of the sixth Five-Year Plan, triggered by a serious drought, had diminished the availability of real resources. Mechanisms existed for helping the states' financial position.

The staff had already pointed out that the Central Government intended to play an important role in the power sector, which was mainly the responsibility of the states, and had already assumed the responsibility for building several large interstate power plants, Mr. Malhotra observed. The Indian constitution provided for a division of powers and responsibilities between the center and the states. It also required that every five years a Finance Commission would look into the devolution of financial resources from the center to the states. A Finance Commission currently at work would issue its report in 1985. Apart from that, the Planning Commission examined questions of development aid to states constantly. Of course, the states themselves tried to resolve their financial difficulties on an ongoing basis.

The various measures taken by the Reserve Bank of India in immobilizing a part of the liquidity in the banks should have a rather large impact, Mr. Malhotra went on. The successive increases in the cash reserve ratio and the higher threshold of refinancing for food credit should reduce the potential for increases in bank credit considerably. He agreed with the staff that the rise in prices had been faster than the Indian authorities had expected. The Reserve Bank of India had also been mindful of the fact, noted in the staff report, that the restrictive measures taken in 1981 had led to a tight squeeze on credit, and had affected some industries.

Should the rise in prices turn out to be over 9 percent, instead of 7 percent as originally expected, and should the economy expand at the projected rate, then the monetary targets would become stricter, Mr. Malhotra said. A point might well be reached where the money supply could become a constraint. In his view, the restrictiveness of the monetary policy had not become apparent because the demand for credit had been rather low. The difficulty had not been caused by large credit creation.

On the exchange rate, Mr. Malhotra pointed out that Chart 11 on page 66a of SM/84/15 indicated that from 1950 to 1964, the competitiveness of the rupee had been quite high. There had followed two and one half years in which the real effective exchange rate had appreciated. Subsequently, the real effective exchange rate had stayed competitive. If the 1950 figure were set at 100, the real effective exchange rate of the rupee had fallen from a high of 118 in 1965 to about 70 by 1982. The upper chart on the same page showed that since 1966 wholesale prices in India had remained lower than foreign prices adjusted for exchange rate changes. He agreed that everything should be done to keep the exchange rate realistic. The rupee had depreciated by about 4 percent during the first year of the program but no attempt had been made to reverse that movement. However, considering the broad direction in which competitiveness was evolving, the authorities were not overly troubled by short-term fluctuations. Similarly, the authorities had avoided indexing interest rates to high inflation in the wake of shortages due to bad weather. They had concentrated on bringing down inflation first while maintaining a stable and realistic framework of interest rates.

According to Mr. Laske, agricultural development in India was restricted to a few areas in which there was irrigation, Mr. Malhotra recalled. It was true that, considering the factor endowment of particular areas, production had been higher where good irrigation or abundant rainfall was available. However, advances had been made in several agricultural regions and technologies.

Under the Plan, electrical capacity had originally been projected to rise from 31,000 megawatts to 51,000 megawatts, an increase of almost two thirds, Mr. Malhotra noted. The new target of 46,000 megawatts, which was likely to be achieved, represented a 47 percent increase in five years. As about 40 percent of power capacity depended on hydroelectric sources, shortages of rainfall often diminished the country's power generation and led to problems.

India's exports under bilateral arrangements had declined or had not grown as the authorities might have wished, a point that had led some Executive Directors to point to the supposed dangers of a bilateral payments system, Mr. Malhotra recalled. He had found the comments difficult to understand as, until only two years previously, the growth of exports to the bilateral area had been high, on the order of 100 percent in a few years. It had also been said that India had rightly reduced its dependence on exports to a particular area. The correct position was that the Indian authorities were looking for markets everywhere without trying to reduce exports to any particular area. The latest figures showed that exports to the other trading areas were growing at a fairly satisfactory rate.

An observation had been made by Mr. de Vries that India would have to choose between efficiency and equity, Mr. Malhotra said. If Mr. de Vries meant that there was some imbalance between consumption and investment, India could not be faulted for being too consumption-minded. Perhaps Mr. de Vries had been alluding to Indian policies vis-à-vis large and small industries. In large industries, employment had been quite sluggish. While efficient enclaves existed in large cities like Bombay or Calcutta, people in most parts of India could well question the relevance of such enclaves to the masses at large. That was why the authorities emphasized adequate dispersal of industries. As to import controls, he doubted whether they were considered constraints to efficient production at present.

Many industrial regulations had been eliminated. It augured well that a debate was going on among industrialists, economists, and academicians about how industrial and import policies affected efficiency and what policy changes were necessary. In conclusion, he expressed satisfaction at the relationship between the Fund staff and the Indian authorities, which was based on mutual confidence and had contributed to the success of the program.

The Chairman made the following summing up:

Executive Directors expressed general agreement with the thrust of the appraisal in the staff report and commended the Indian authorities on the progress achieved under the adjustment program for 1983/84. Directors noted that the economy was on the path to recovery following the drought-related difficulties in 1982/83, and that GDP was forecast to rise by 6-6.5 percent in 1983/84. Aided by favorable weather, agricultural output was rebounding strongly, and foodgrain production was likely to set a new record. While industrial output had remained relatively subdued, the outlook was for an acceleration of activity. In this context, Directors observed that supply problems in some basic industries and in infrastructure, especially electric power, had impeded a rapid industrial recovery, and could continue to be an adverse factor. Demand management policies would have to take account of these supply constraints.

Directors noted that, following a period of low inflation, wholesale prices had risen more rapidly in 1983, to an annual rate of 11 percent by January 1984. Directors viewed the rise in inflation with concern. They observed that monetary growth had accelerated in the first half of 1983/84. However, credit policies had been tightened, including the recent introduction of an incremental cash reserve requirement, and monetary growth rates had been somewhat reduced. Nevertheless, in view of the priority that must be attached to reducing inflation, it would be essential to maintain a flexible and cautious policy stance in order to ensure that monetary growth was contained to rates in line with those in the financial program for the year as a whole. The need to pursue an interest rate policy that effectively encouraged private financial savings was also stressed by a number of Directors.

Directors observed that public expenditure had been running ahead of target; the Central Government's budget deficit in 1983/84 had been expected to be significantly above the program estimate and to exceed 7 percent of GNP. The rising trend in the structural deficit of the general government was viewed with some concern. Directors believed it necessary that expenditures be curbed and bank borrowing reduced. This would be helpful, in conjunction with monetary policy, in combating inflationary tendencies. Directors therefore welcomed the recent announcement by the Government that expenditures would be reduced substantially in 1983/84. They commented favorably on the stronger than targeted increase in public savings now expected in 1983/84. However, the profits of central public enterprises had been eroded by cost increases. In this context, Directors welcomed the recent announcement of increases in prices for coal and rice, and emphasized the need for continued flexibility in pricing policies. They also expressed hope that an economically based decision on fertilizer prices would be reached soon. Many Directors expressed disappointment about the limited progress achieved in the savings performance of the states during the extended arrangement. So far, resource mobilization measures in 1983/84 had been below target, and resources available to finance state plans, including investments in key areas such as electric power and irrigation, were insufficient. Directors urged resolute steps to increase resources for the states so that financial difficulties at the state level did not prejudice national priorities.

Directors noted that both the current account and the overall balance of payments were now expected to be more favorable in 1983/84 than estimated earlier. It was observed that this was the result of lower non-oil imports, higher private transfers, and larger nonmonetary capital inflows. Lower than expected growth in imports partly reflected sluggishness of domestic demand. Noting that the import liberalization measures introduced earlier in the year were having a smaller than expected effect, Directors expressed the view that it was important to continue the thrust of policy changes, including those in the areas of import and industrial liberalization, in order to strengthen the economy's efficiency and competitiveness. Directors were concerned about the weakness in the export performance in 1982/83, and the still uncertain prospects for 1983/84. Noting recent indications of an improvement in export performance, Directors emphasized that export development efforts could not be relaxed; rather, they needed to be intensified. In this context, the exchange rate was of particular importance; developments in competitiveness should be watched carefully, and policies adapted flexibly.

Directors welcomed the recent announcement by the Government of India of its intention to cancel the extended arrangement at the end of the current year's program. This action would significantly improve the Fund's liquidity position. Looking back over the period of the extended arrangement, Directors noted the important progress achieved under the balance of payments adjustment program, despite an unfavorable external environment. India's decision to approach the Fund in 1981 at an early stage of its difficulties was recalled with commendation.

There had been dramatic growth in the production of petroleum, a major increase in foodgrain production, and satisfactory rates of saving and investment. Notable gains in capacity and output had been achieved in coal, fertilizer, and cement, but shortfalls had been recorded in the targets for electric power capacity and irrigation. Although export growth had been inadequate, the external position was stronger than originally envisaged, mainly because of lower import volumes of important items, including oil, reflecting increased domestic output, moderation in oil prices, and constrained demand. Overall, there had been marked increases in public savings, which had facilitated stepped-up plan investments in essential areas needed for adjustment without excessive domestic or foreign borrowing. Taking the program period as a whole, inflation had generally been brought under greater control and competitiveness and efficiency increased by a degree of liberalization of imports and industrial regulations, although further progress in these areas was necessary.

Looking toward the future, Directors welcomed the resolve of the Indian authorities to persevere with the adjustment strategy. Efforts would be needed to limit the current account deficit in order to assure external viability in the second half of the 1980s, when the debt service burden would have increased. These efforts should be directed mainly at improving exports, and also at containing the public sector's savings/investment gap. Many Directors also stressed the need to take resolute action to advance the process of domestic and external liberalization to promote business activity and investment further. India was encouraged to simplify its exchange system and to reduce its reliance on bilateral trade and on special export incentives. With a comprehensive balance of payments strategy and reasonable conditions in the world economy, prospects were favorable for India to attain a viable balance of payments position in the medium term without reliance on exceptional financing. India was commended on its excellent standing in international credit markets.

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

The Executive Board then took the following decisions:

Decision Concluding 1984 Article XIV Consultation

1. The Fund takes this decision relating to India's exchange measures subject to Article VIII, Section 2, and in concluding the 1984 Article XIV consultation with India, in the light of the 1984 Article IV consultation with India conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The restrictions on the making of payments and transfers for current international transactions described in SM/84/15 are maintained by India in accordance with Article XIV, except that the restriction arising under the remaining bilateral payments agreement with a Fund member is subject to approval under Article VIII, Section 2. The Fund encourages the authorities to terminate the bilateral payments agreement with a Fund member as soon as possible and to simplify the exchange system further.

Decision No. 7615-(84/17), adopted
January 27, 1984

Review Under Extended Arrangement

The Fund and India have completed the review contemplated in paragraph 3(c) of the decision on the program for 1983/84 under the extended arrangement for India (EBS/83/130) and in paragraph 3 of the letter dated June 8, 1983, attached thereto. No new understandings with the Fund are necessary regarding circumstances in which purchases may be made by India under the extended arrangement until June 30, 1984.

Decision No. 7616-(84/17), adopted
January 27, 1984

3. ITALY - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with Italy (SM/83/269, 12/30/83). They also had before them a report on recent economic developments in Italy (SM/84/10, 1/12/84; and Sup. 1, 1/26/84).

Mr. Lovato made the following statement:

While my Italian authorities appreciate the staff appraisal of the current situation and its discussion of the measures needed to overcome the imbalances characterizing the Italian economy, they wish to highlight a few areas where they are at variance with the staff in assessing the likely economic outcome for 1984.

As the staff describes with great accuracy in its report, Italy has experienced a prolonged recession in domestic demand and output, which began in 1981 and continued through 1983. As real personal disposable income fell, private consumption declined in 1983 after stagnating for two years. Investment decreased markedly, as a reflection of the unfavorable constellation of high real interest rates, shrinking profit margins, and low capacity use. Unemployment climbed to nearly 10 percent, or

12 percent of temporarily laid-off workers under the Wage Supplementation Fund are included. Real GDP is estimated to have dropped by about 1.5 percent year on year. The deceleration of inflation has continued along the trend, although at an insufficient pace, compared with disinflation in most other industrial countries. These industrial prices decelerated to about 10 percent in 1983, as prices of imported inputs rose moderately. Consumer prices recorded a much higher increase--15 percent year on year, almost 13 percent by end-1983--as a consequence of higher profit margins in the distribution and tertiary sectors and appreciable increases in administered prices and public tariffs. The modification of the scala mobile mechanism reduced by 15 percent the implied degree of indexation and, together with the mutually consented ceilings in the wage contracts negotiated for a three-year period, moderated nominal wage developments. While real wages have remained largely unchanged, unit labor costs are estimated to have increased by about 17 percent as a reflection of rising social contributions and declining productivity.

The picture on the external front has been much more favorable. Recently released figures on trade flows indicate a marked contraction in the trade deficit for 1983. The sizable pickup in world demand coupled with a smaller than expected domestic recovery in Italy and improved terms of trade are projected to lead to a trade deficit oscillating around Lit 10,000-11,000 billion--after nearly Lit 17,000 billion in 1982--while the current account should swing from a deficit equivalent to 1.6 percent of GDP in 1982 to a moderate surplus, or 0.2-0.4 percent of GDP. In value terms, according to preliminary estimates, merchandise exports rose in 1983 by 11-12 percent and imports by 4-5 percent. Given the slow rise of export prices, export volumes are estimated to have increased at an appreciable pace. The overall balance recorded a sizable surplus of Lit 3,800 billion, resulting in a significant accumulation of official reserves, which returned to their comfortable 1981 levels. For 1984, the official forecasts are largely in line with those of the staff except for a more favorable outlook for inflation.

My authorities recognize that the situation of the public finances in Italy is indeed serious, and they are prepared to implement the necessary measures to correct it. While appreciating the candid assessment offered by the staff, they think that it should not be overalarmist.

In this respect, I believe that the proposition "new spending legislation continues to be approved by Parliament with little apparent concern over its costs to the budget" tends, alongside others, to give the wrong impression that events are no longer under control and that the policy goals and commitments made by the Government are not credible. Moreover, as regards the general policy framework for 1984, the staff seems to attach little or no importance to the impact of incomes policies on price dynamics. My authorities, instead, underscore that incomes policies can be instrumental in reducing inflation and can help to trigger a virtuous cycle between disinflation, declining interest rates, and a shrinking public sector deficit.

Current trends in labor costs and public finances are the outgrowth both of long-standing traditions and, partly for the latter, of the recent prolonged recession. The Italian authorities are fully aware of the necessity of important corrections in these two policy areas, and recent legislation should be seen as a first move in the right direction.

With regard to fiscal policy, new provisions introduced in the 1984 budget--increases in direct and indirect taxes and cutbacks in public transfers under social security and national health insurance--are expected to have an appreciable impact on the state sector deficit, thereby reversing its current trend of growth as a proportion of GDP.

A supplementary measure--an increase in petroleum products prices--has already been approved. Others, on both the revenue and the expenditure sides, may be enacted in the course of the year as the budgetary situation is kept under constant review.

The overall outcome should be seen as a first step, but nevertheless it represents a significant accomplishment in present circumstances. Moreover, it would be a mistake to ignore the growing consensus for fiscal restraint in political, managerial, and academic circles; this climate of public opinion cannot fail to produce its effects in shaping the stance of fiscal policies in the years ahead.

My authorities were interested in the simulations prepared by the staff on the medium-term dynamics of the public debt, especially the illustrative scenarios in Appendix II of SM/84/10. On that matter, they wish to make the following observations. First, meaningful inferences cannot be drawn from oversimplified models, which, among other questionable exogenous assumptions, do not account for the reduction in inflation that is likely to follow from an incomes policy pact. Second, it is important to distinguish between public debt contracted abroad and public debt financed domestically. In the former case, if debt-financed spending is not directly productive, the debt service burden shifts resources away from the country; in the latter, the consequences are primarily of a redistributive character among resident agents.

In income determination, the officially stated policy objectives for 1984 envisage a growth rate of labor costs to be kept in line with the programmed rate of inflation of 10 percent. Incomes policies are meant to reduce the output and employment costs associated with disinflation. In this connection, the debate on the scala mobile has been reopened with a view to reaching a lasting solution to the problem. A positive result of this debate needs to carry a wide consensus to be viable and effective. The outcome of the tripartite negotiations is still uncertain, but a government proposal, recently submitted to the social partners, would entail that the number of scala mobile points to be paid during 1984 would be predetermined consistently with the target inflation rate. Prospects for a near-term agreement on the issue are regarded as encouraging by my authorities.

As on previous occasions, in 1983 monetary policy has had to perform a pivotal role in steering the economy along the desired stabilization path. The authorities committed themselves to ensuring the necessary restraint in the growth of monetary aggregates in the course of 1983; M-2 grew by 13 percent, according to preliminary data, and credit expansion to the private sector was maintained below the growth rate of nominal GDP. For 1984, a continued restrictive stance has been restated. Real interest rates, positive at present, are not expected to decrease in order to finance the public sector borrowing requirement largely through nonmonetary means.

The authorities have made wide innovations in techniques of monetary control in recent years. Following the "divorce" between the Bank of Italy and the Treasury in 1981, more room was made for an active open market policy, despite the constraints arising from the growing borrowing requirement of the public sector. A wider spectrum of financial instruments was offered to the public, encompassing indexed medium-term credit certificates, bonds linked to the European Currency Unit (ECU), and real-indexed treasury securities, designed to lengthen the average time structure of the public debt and enhance the nonmonetary financing of the budget deficit. Important results were attained: the average maturity of public bond issues rose in 1983 from one year to nearly three years, and the ratio of medium-term and long-term securities to the government debt as a whole climbed from 23 percent to 33 percent in the first nine months of the year.

More important, credit ceilings, a central feature of the apparatus of monetary policy in Italy since the 1970s, were removed in 1983. The moral suasion exerted vis-à-vis the banking system as a monitoring device was also discontinued toward the end of the year. The authorities, aware of the allocative costs of a prolonged use of credit controls and of their inherently decreasing effectiveness over time, are resolved to continue their policy shift toward greater reliance on market instruments rather than administrative directives in monetary management.

The exchange rate of the lira, following the realignment within the European Monetary System (EMS) last March, has been remarkably stable vis-à-vis the European currencies, albeit with a moderately declining trend in the central part of the year. It depreciated much more markedly against the U.S. dollar--by 16 percent over the 12 months ended December 1983. According to Italian estimates, the real effective rate, as measured by relative wholesale prices in manufacturing, appreciated by 3 percent year on year but remained unchanged in the course of the year. Losses in competitiveness were thus confined to the earlier part of 1983.

The improved balance of payments outlook, together with an increasingly outward-looking dimension characterizing the Italian economy, has prompted my authorities to envision an overhaul of the existing heavily regulated system of international payments. A reform bill, recently submitted to Parliament, if introduced, would make fundamental innovations in a tradition of restrictions on capital movements that has prevailed in Italy since the early 1970s. Such a far-reaching liberalization would be implemented with some gradualism, following a long period of reliance on regulatory controls, and could be tempered under specified circumstances by the requirements and goals of monetary policy. Some measures have already been enforced in this area: intra-EC trade credits, which had previously required specific authorization, are free; and overseas direct investment is exempt from the interest-free deposit on capital transfers abroad unless a specific objection is raised within 15 days.

The bill being discussed by Parliament envisages, inter alia, a liberalization of the existing practices regulating the allocation of foreign exchange for tourist travel. These restrictions have been introduced and maintained with the sole purpose of preventing illegal capital outflows. The annual allowance was raised in 1983 from Lit 1.1 million to Lit 1.6 million. This increase, if properly deflated by a weighted average of travel-related service prices in countries representing major destinations of Italian tourists abroad, seems to be sufficient to maintain spending power in real terms. It should also be recalled that the allowance is in addition to all travel expenses that can be prepaid in domestic currency.

My authorities remain committed to an open trade and payments system and hope that an improved international environment may permit more liberal trade policies. They stress, however, that the trade restrictions recently imposed were introduced, as in other countries, to overcome the difficult employment situation of specific sectors.

I wish to underscore my country's record in official development assistance (ODA). It has increased sharply since 1981, with a target of reaching the UN recommended ratio of 0.7 percent of GDP by the end of the decade. Committed figures for ODA in 1983 have shown a pronounced rise of over 30 percent in nominal terms.

Mr. Grosche expressed broad agreement with the staff's assessment and recommendations. The staff papers clearly demonstrated that the performance of the Italian economy had been unsatisfactory. A number of improvements had been recorded: the economy had passed the trough of the recession, and the improvement in the current account was encouraging. Nevertheless, the high and still growing budget deficit, the widened inflation differential with partner countries, unprecedentedly higher unemployment, and reduced competitiveness in the private sector hardly provided a sound base for a sustained recovery in economic activity.

On fiscal policy, the root of the problem was excessive public spending favoring consumption over investment, Mr. Grosche continued. The gap between the authorities' recognition of the problem and their decision to take appropriate action appeared to be particularly large in Italy compared with other countries in Europe. Successive Italian Governments had set themselves reasonable targets to contain public spending, but none had attained them. Unless action were taken, the situation would become worse and might even get out of hand.

Since 1980, Mr. Grosche observed, interest rates had been positive. As inflation was no longer reducing Italy's debt burden, the interaction between interest payments and budget deficits had clearly intensified. The scenarios presented in Table 4 of SM/83/269 and in Appendix II of SM/84/10 were quite alarming. While it could be argued that the models used might be oversimplified and mechanical, they did provide useful information about trends in case certain assumptions materialized. It would be helpful if the staff included such scenarios in papers for consultations with other countries.

There was no doubt that the Italian authorities had to reduce the budget deficit, but there were various ways to achieve the goal, Mr. Grosche remarked. One possibility would be to increase direct and indirect taxes, but, considering the already high tax burden, particularly on wage earnings, the authorities appeared to have little scope for such increases. In the medium run, they should raise public sector savings by reforming the tax structure as well as making improvements in tax collection and tax administration. The main way to reduce the budget deficit would be to spend less. It was encouraging to hear from Mr. Lovato that the authorities had taken important steps in the right direction, such as cutbacks in public transfers under social security and national health. Nevertheless, the authorities were likely to overshoot the announced target for the 1984 budget deficit by a large amount unless they took additional corrective measures.

He greatly appreciated Mr. Lovato's assurance that his authorities would keep the budgetary situation under constant review, Mr. Grosche said. With the staff, he would encourage them to prepare a substantial package of additional measures for 1984. He fully supported the recommendations for change made by the staff.

Italian producers had been suffering a growing loss of competitiveness due to the rising costs of capital and labor, Mr. Grosche noted. After interest rates had become positive in 1980, the sharp decline in the share of borrowing by the private sector from 46 percent to only 24 percent in 1983 clearly showed that crowding-out had taken place. Total investment had also declined by 10 percentage points in the same period. Excessive increases in labor costs had impaired Italy's competitiveness even more: although wages had risen by only 16 percent in 1983, labor costs had nonetheless risen by 18 percent owing to idle capacity. There was an urgent need for trade unions, employers, and the Government to moderate wage increases. As labor costs squeezed profits, industrial enterprises sought more and more to accelerate the substitution of capital for labor, despite the high capital costs involved. As one consequence, the public budget had to take on an additional burden because the Wage Supplementation Fund had to step in.

In no event should the initially envisaged growth rates in the cost of labor exceed the programmed rate of inflation, Mr. Grosche considered. He welcomed Mr. Lovato's statement that a debate on the matter had been reopened with a view to reaching a durable solution, and that the Italian authorities regarded prospects for near-term agreement encouraging. Unless the growth of labor costs could be contained, the competitiveness of Italian exports would continue to be seriously impaired. Competitiveness had already been worsened by the significant appreciation of the real effective exchange rate for the lira in 1982 and 1983. While no further losses in competitiveness seemed to have occurred since then, the exchange rate would come under pressure if action against cost-push should fail. However, a devaluation of the lira, together with the deterioration in the terms of trade, would trigger another round of cost and price pushes that would be even more difficult to curtail.

Italy could play a larger role in promoting a more liberal trade policy both within and outside the European Communities, Mr. Grosche concluded. Finally, he agreed with the staff that the recent move to allow tourists to buy more foreign exchange represented a step in the right direction, but it fell short of what could be expected in view of the state of the balance of payments.

Mr. Senior expressed agreement with the staff appraisal. He hoped that the staff's analysis of Italy's public debt would serve as a model for reports on other countries marked by fiscal imbalances of a similar nature. The recent macroeconomic history of the Italian economy showed that its most salient feature appeared to be its departure from the path followed by other major industrial countries. Indeed, it was difficult to assess whether the Italian economy was moving gradually toward equilibrium or away from it. At any rate, the authorities were faced with the choice of either making wide-ranging changes in the country's economic structure or entering into a period of cumulative disequilibria that would reduce the future potential for growth of the economy. Clearly, Italy's present fiscal imbalance was unstable; as the staff had said, there was little room for delaying an adjustment effort.

The negative role played by the indexation system in the deterioration of the trade-off between growth and inflation had been generally acknowledged, Mr. Senior said. The authorities were to be commended for improving the adjustment mechanisms by significantly reducing the degree of indexation to past inflation. However, the inertia and the rigidities still existing in the labor market had prevented any significant improvement in real wages or in labor costs. In 1984, labor costs were still projected to grow rapidly, despite the agreement among the social partners to modify the scala mobile. Not surprisingly, such wage rate behavior as the 18 percent rise in unit labor costs in 1983 had been associated with increasing levels of unemployment and corresponding pressures on public spending. Italy's economic problems seemed to be poorly suited to the slow-working process of adjustment brought about by indexation mechanisms. If labor cost tendencies remained unchecked, in the absence of large positive external influences, the economy would sooner or later have to deal with a rapid adjustment requiring fundamental changes in wage determination. It was encouraging that the debate on the scala mobile had been opened with a view to reaching a lasting solution.

The fiscal imbalances and labor imbalances in Italy were related, Mr. Senior considered. At current wage rates, cutbacks in public expenditure, in particular current public expenditure, would lead to a substantial rise in unemployment, which in turn would rapidly restore the initial level of public spending. Under those circumstances, he agreed with the staff that a dialogue among the social partners aimed at devising workable policies might prove fruitful. Fiscal discipline could not be obtained at a time when real wages or real labor costs were inflexible downward.

The crucial issue was to determine the pace of adjustment required to prevent a cumulative deterioration of fiscal performance in the rest of the economy in the years ahead, Mr. Senior remarked. In that respect, he had greatly benefited from Appendix II in SM/84/10 on the dynamics of the public debt in Italy and also from Table 4 in SM/83/269, which presented two scenarios of possible medium-term developments in the public sector. He would however have preferred to see a scenario between Scenario A, which was predicated on no adjustment, and Scenario B, which was predicated on rapid adjustment. The views of the Italian authorities no doubt fell between those two extremes. He would have found it most interesting to see whether a not-so-rapid adjustment could be sufficient to prevent the public sector deficit from rising out of control. In the light of his comments about the usefulness of such scenarios for other countries, it would be even more useful if, in addition to the dynamics of the public sector deficit, the staff could include in the future some figures on associated developments in the current external balances of member countries.

Indeed, throughout the papers, the staff had presented many comments on the probable evolution of private investment and savings ratios that could be integrated into such a table. After all, the length of the period during which a country could sustain a given public sector deficit depended greatly on how large the available resources were to finance it. In an open economy, the availability of external savings was the ultimate constraint on the growth of fiscal imbalances. As Mr. Lovato had pointed out, views on problem areas in the public sector deficit and in external current account balances were highly judgmental. Nevertheless, by providing figures on such problem areas, the staff would help Executive Directors to assess whether adjustment in countries should be gradual or rapid.

In conclusion, he had no doubt that the Italian authorities were well aware of the need to correct the fiscal imbalances built into the economy, Mr. Senior remarked. He was certain that they would stand ready to accelerate the pace of adjustment should external or internal developments make such a correction advisable.

Mr. Leonard said that the staff report furnished a clear exposition of the current situation in Italy and its immediate prospects. He concurred with the staff that the primary causes of Italy's weak performance had been the excessive growth of public expenditure and the widening public sector deficit. Successive Italian governments had been of the same view, but political and social factors had inhibited the adoption of corrective measures. The rise in the public sector deficit to 17 percent of GDP in 1983--compared with a targeted 13.5 percent--was particularly disappointing in light of the authorities' failure to implement the announced increases in taxes and reductions in spending. The built-in weakness of public finances was highlighted by the staff comment that, even if the noninterest part of the deficit were halved relative to GDP by 1986 and practically eliminated by 1990, the ratio of public debt to GDP would still continue to rise until almost the end of the decade.

The authorities would have to tackle their problems with the utmost vigor, Mr. Leonard considered. Fortunately, social and business circles might at last be ready to accept the path of correction. The actions that would be taken in the coming year by the present Government, which had made a return to greater fiscal balance a priority, would be critical. As the staff had pointed out, an overrun of the target would result in higher real interest rates and a further acceleration of inflation; such developments would not augur well for private sector investment, which had long been weak. A great deal depended upon the authorities' willingness to carry through additional measures should it appear that the targets would be overrun. He urged them to adhere to their announced intentions.

The forthcoming review of the scala mobile should build on the start made in January 1983, Mr. Leonard went on, and should seek to impose further exclusions from indexation mechanisms of the effects of indirect taxes. In turn, such exclusions would provide an opportunity for the

Government to correct its excessive reliance on income taxes and also to reduce tax evasion and avoidance. The staff might wish to suggest other possible measures to enhance revenue.

In recent years, the scala mobile had provided compensation for inflation equal to 65-70 percent of the inflation rate, Mr. Leonard said. There would thus be some scope for constraining the expansion of real wages, provided that contractual increases were moderate. In light of the provision in the tripartite agreement of January 1983 that real wages would be maintained as the price for other limited reforms in the wage determination system, the staff had done well in advising that the authorities should be careful not to pay too high a price for reforms in the system. Could Mr. Lovato furnish additional details of any progress achieved in the 1983 incomes policy talks?

Given the overexpansionary stance of fiscal policy, monetary policy had had to assume most of the task of holding the line against severe inflationary pressures, Mr. Leonard observed. In general, the monetary stance appeared to be one of the few elements standing in the way of an even worse deterioration of the economic situation, although there had been regrettable but understandable costs in the form of lost private investment. For 1984, in order to avoid reducing credit to the private sector, the authorities would probably allow a sizable budget overrun to result in a higher rate of inflation than currently targeted, even though the inflation differential between Italy and its main trading partners had been widening. Without a large decrease in public sector deficits, there appeared to be little scope for resolving the conflict between meeting the credit needs of the private sector and risking greater inflation. From the standpoint of efficient resource allocation, he would support the reduction in administrative controls in the conduct of monetary policy, which had particularly discriminated against private investment. His major concern was the need for the Government to come to grips with the fiscal problem soon.

The staff noted, Mr. Leonard went on, that a large part of the reduction in the current account deficit as a proportion of GNP could be attributed to the steady slowdown in growth since 1980. While an improvement in the terms of trade had been responsible for part of the reduction in the deficit, that trend was unlikely to continue. The small appreciation in the real effective exchange rate for the Italian lira since the start of 1982 could scarcely be expected to continue at a time of widening inflation differentials between Italy and its trading partners. Any further appreciation would also be inappropriate if it meant an intensification of trade barriers. Apart from the effects on other countries of such an intensification, more protectionist measures would delay the required structural adjustment of the Italian economy and limit the scope for sustained economic recovery. The impact of the effective appreciation of the lira on productivity and wage demands would appear to be of somewhat lesser importance.

Mr. Schneider said that, although Italy had maintained an acceptable degree of stability, it had had less success than other industrial countries in adapting to the changed world environment. The lack of progress by the authorities in speeding up long-overdue adjustments, especially in the fiscal field, did not suggest that they were unaware of the problems or unwilling to solve them; it was, rather, a reflection of the variable political climate, in which frequent changes in government occurred. Consequently, the authorities tended to rely more on administrative interventions and on restrictions. He therefore shared the staff's concern that the medium-term and long-term prospects for the economy were not promising unless the authorities took strong measures quickly. Although they wished to achieve a sustainable recovery at the lowest possible social cost, they could not do so by permitting an ever-growing fiscal deficit. He agreed with the staff that either the resulting crowding-out of private sector borrowing, together with high interest rates, or the possible inflationary effects of the deficit could eventually reverse the expected modest recovery and lead to increased unemployment. The large public sector deficit could easily prove to be counterproductive, in that it might exacerbate the social tensions that growing deficits had been intended to alleviate in the first place.

He welcomed the new provisions introduced by the Italian authorities in the 1984 budget, which aimed at reversing the current trend of expanding deficits as a proportion of GDP, Mr. Schneider remarked. However, the new provisions were only one step in the right direction. Others ought to follow soon in order to keep up the momentum. A correction of fiscal policy would also ease the pressure on monetary policy, which had become the main tool for checking the growth of monetary aggregates. He also doubted whether the scala mobile would really lead to the necessary differentiation according to labor and productivity or whether the incomes policy could serve as an effective means of improving the trade-off between inflation and unemployment in the absence of adequate financial policies. Moreover, the relative appreciation of the lira had neither contributed significantly to lessening inflationary pressures nor led to substantial gains in productivity. In present circumstances, a continued appreciation would trigger a loss in competitiveness.

The maintenance by the Italian authorities of existing trade barriers, the increase in trade restrictions, and the limit on foreign exchange for tourist travel were by no means substitutes for necessary economic policy measures, Mr. Schneider considered. In the past, the Italian authorities had often been criticized for not taking needed actions but had nonetheless managed to cope with their difficulties in one way or another. He hoped that they would overcome their current difficulties through pragmatism.

Mr. Templeman commented that for a number of years the Italian economy had demonstrated a stop-go push as a result of sharply rising unit labor costs and large budget deficits, compounded by external shocks. The causative factors of inflation had been diffused by wage indexation, while cost pressures had been accommodated by a monetary policy heavily influenced by the need to finance large budget deficits. Under pressure from balance of payments constraints, the authorities had periodically imposed controls on credit, which, coupled with depreciation of the lira, had squeezed profits, reducing investment and demand until the original pressures had subsided and the balance of payments position had strengthened. Meanwhile, unemployment had been cushioned by restrictive labor laws and practices and also by temporary payments from the Wage Supplementation Fund. A sizable underground economy in which small and medium-sized businesses could ignore contractual wage rates, social insurance, and tax obligations had helped to absorb many of the temporarily unemployed and to support real economic activity while taking advantage of export opportunities. The difficulty with Italy's pattern of development had been that, after each cycle, the underlying levels of inflation and unemployment had tended to be higher and the balance of payments weaker than previously, with the trade-off between growth and inflation worsened.

As the staff had said, Mr. Templeman noted, the diagnosis of the causes of Italy's economic problems had been widely recognized for some time, even by a series of governments that had been unwilling or unable to bring about the needed policy changes. As a consequence, Italy continued to march out of step with the other industrial countries with which it had to compete both in the domestic market and in world markets.

It was unfortunate that unit labor costs, the inflation rate, the size of budget deficits, the burden of interest on the public debt, and the size of the public debt itself were generally higher than in Italy's major trading partners, Mr. Templeman continued. Moreover, the Wage Supplementation Fund, which was meant to provide only temporary income support, had become a permanent burden on the budget. At the same time, the wage compression effect of the <u>scala mobile</u> had reduced wage differentials, adversely affecting productivity incentives and efficient resource allocation. On the positive side, the adverse developments had helped to persuade labor, business, and government to reassess the problem of rapidly rising labor costs and the functioning of the wage indexation system.

The principal reason for the growing budget deficit had been the rapid expansion of transfer payments for social insurance to local governments, and, to a lesser extent, to enterprises and households, Mr. Templeman said. Transfer payments in the state sector budget had grown by more than 30 percent in each of the past three years, and represented 46 percent of total current expenditure while interest rates remained above 19 percent. Thus, the authorities had little room for maneuver without addressing those two critical components.

Several specific areas of the budget needed attention, Mr. Templeman went on. First, to a large extent, social insurance expenditure was still being financed by transfers from the Government rather than from taxpayers' contributions. Second, the taxing authority of local governments was too small in relation to their spending obligations. Third, in recent years the Government had substantially expanded its transfer payments to and equity participation in state enterprises, whose persistent financial losses were worrying not merely because of their ever-growing burden on the budget, but also because those enterprises constituted a major component of Italy's economic structure. In that respect, the figures reported in Table 59 of SM/84/10 were especially disturbing, as they showed that the losses of the Istituto per la Ricostruzione Industriale (IRI), the Ente Nazionale Idrocarburi (ENI), and the Ente Participazione e Finanziamento Industria Manifatturiera (EFIM) had represented about 5 percent of sales during each of the past seven years.

Given the size of the budget financing problem, Mr. Templeman said, he had to admire the artful way in which the authorities had sought to manage monetary policy, employing both market-related and indirect controls in an effort to contain the inflationary impetus. Of course, a reduction in the deficit itself would have been better, since persistent negative public savings had the effect of absorbing household savings that might otherwise have financed productive investment in the private sector. Crowding-out of the private sector was also evident in the rise of the state sector's share of total credit from 54 percent in 1980 to 76 percent by the first half of 1983.

Italy had achieved a notable turnaround in the balance of payments following the second oil shock, Mr. Templeman remarked. But, while the current account would perhaps register a small surplus in 1983, the external accounts were in a much weaker position than would be desirable. Did the staff have any further comments on Italy's present competitive position, following the real effective appreciation of the lira during at least part of 1983? The loss of market shares by Italy, which appeared to be continuing, was also a matter for concern.

One positive development had been the agreement concluded in 1983 by business and labor to limit wage indexation to 85 percent of the calculated adjustment and to set industry-wide ceilings on three-year contractual wage increases for 1983-85, Mr. Templeman observed. At present, talks were under way on a possible reduction in the incidence of indirect taxation, on exchange rate effects on the scala mobile index, and on the Government's proposal to limit labor costs so that they did not exceed the targeted inflation rate of 10 percent. The social partners ought to make greater efforts to moderate the rise in labor costs. On the budget front, the target of limiting the deficit of the state sector to the same figure in lire as in 1983, so that the ratio of the budget deficit to GDP would decline by about 2 percentage points, did not seem assured. Further measures appeared essential to meet the budget target.

Given the improvement in Italy's balance of payments and the country's interest in promoting international travel, he urged the authorities to eliminate the restriction on travel allowances as soon as possible, Mr. Templeman concluded. The reform bill to overhaul the bulk of international payments, which had recently been introduced in Parliament, seemed to offer a good opportunity to liberalize exchange restrictions in general, and the travel allowance in particular.

Mr. Blandin agreed with other Executive Directors that the picture presented by the 1983 figures was hardly a brilliant one; indeed, developments in the Italian economy posed a challenge to traditional theory. There had been both a sharp decrease in the major components of domestic demand and exceptionally high public consumption. Despite the shrinkage of GDP, the sharp decrease in industrial production, and the rise in unemployment, the figures provided by the staff did not indicate that any of the positive effects normally expected, such as lower inflation or a better position on external accounts, had come to pass. He was however pleased to note from Mr. Lovato that Italy would have a small current account surplus in 1983.

Developments in the Italian economy were worrying for at least two reasons, Mr. Blandin continued. First, there was a risk that any pickup in domestic demand could lead to an acceleration of inflation, which would be all the more lamentable because it would start from an already high rate, one almost unmanageable for any other industrial country. Second, the increase in domestic demand during a recovery could also lead to a rapid deterioration of the external balance, all the more so because the sharp increase in investment could have worsened Italian competitiveness.

The two staff papers contained interesting references to the so-called underground economy, which largely escaped the wage and tax arrangements agreed upon above ground, Mr. Blandin said. However, the staff had made only a few comments on the economic impact of the underground sector. Perhaps the growth in that sector explained the surprising reaction of the Italian economy as a whole during 1983, especially the resilience of inflation. Again, despite the high rate of unemployment, at 9.9 percent, unemployment appeared to be rather diffused, thus being perhaps socially less damaging than in other industrial countries. Moreover, a large part of the Italian economy appeared to have shown great skill at adapting to changing circumstances. Many small firms had been successful in promoting their products abroad, and the automobile industry was being restructured. Therefore, he was more sanguine about the outlook for Italy than would be warranted from an examination of the economic statistics alone. As the staff and Mr. Lovato noted, a certain consensus had emerged on the corrections needed in economic policy.

He had been greatly interested in the medium-term scenario for the public sector presented in Table 4 of SM/83/269, Mr. Blandin stated. It would however have been helpful to chart the trends of the aggregates during the two or three preceding years. In addition, one scenario was overpessimistic, projecting a rapid increase in expenditure, while the other was overoptimistic, projecting a sharp decrease in the rate of inflation. A moderate scenario would probably have been more helpful.

The scenarios showed that the Italian authorities would have to take major additional measures, Mr. Blandin considered. First, the evolution of the fiscal deficit as a proportion of GDP was most worrying. In the medium or long term, as in the short term, the deficit seemed to be easily financed by nonmonetary resources. The most worrying consequence was the crowding-out of productive private investment, especially since the pattern of public spending in Italy favored consumption over investment. There seemed to exist a vicious circle in which expanding fiscal deficits led to slowdowns in investment, which in turn worsened Italy's external deficits. He agreed with the staff that a sustained improvement would necessarily be progressive and would involve a large range of changes in current spending legislation. On the revenue side, the authorities should move to widen the tax base and improve enforcement, rather than increase pressure on wage earners. He had noted with interest Mr. Lovato's statement that other fiscal measures might be endorsed during 1984. Another area that needed improvement was that of labor costs. The tripartite wage agreement reached in 1983, the first of its type, represented a useful means of reducing the degree of indexation.

The authorities would have to be careful to give the right signals to public opinion, Mr. Blandin observed. Recent improvements in the balance of payments, for example, had certainly been due partly to cyclical factors, and the authorities should take steps to broaden and strengthen the Italian export base. He had been concerned to read on page 81 of SM/84/10 that the growth of Italian exports to developed countries had decelerated sharply in the first half of 1983, and he would appreciate further comments from Mr. Lovato or the staff on that point. In conclusion, he commended the Italian authorities for their commitment to reaching the recommended UN target for ODA of 0.7 percent of GDP.

Mr. Clark remarked that the strongly worded staff appraisal was entirely appropriate, and he fully endorsed the staff's views. The Italian economy suffered acutely from the structural maladjustments common to many industrial countries, but the authorities' failure to act decisively to curb the public sector deficit over the past three years contrasted with performance elsewhere. Moreover, the improvement in wage and cost inflation in Italy had been significantly less than in other major industrial countries. He also found it extremely worrisome that Italy's budget deficit was forecast to continue growing as a percentage of GDP. There was a real risk that the position might become unsustainable. Clearly, the long-term aim should be the reallocation of resources to productive sectors in the economy. As other Executive Directors had noted, the magnitude of the public sector's borrowing requirement, attributable to the expanding deficit, was crowding out borrowing by the private sector, thus undermining the longer-term potential of the economy. The authorities' first priority should be to reverse the rising trend in the public sector deficit by curbing public expenditure. Radical action seemed imperative. Unless progress were achieved on that front, he found it hard to see how any further tightening of monetary or incomes policy could be effective.

Although it seemed to be widely expected that the target of Lit 90 trillion for the 1984 budget deficit would be breached, Mr. Clark continued, the authorities had postponed further action in reducing public expenditure, apparently for fear that radical budget cuts could damage the forthcoming pay talks. On previous occasions, the results of agreements on wages had been ambiguous and costly in terms of fiscal concessions. Against that background, he agreed with the staff that the authorities should act urgently. Thus, he endorsed the staff's call for additional measures, which needed to be introduced soon. Such measures should not only address the problems arising in 1984 but also tackle the underlying causes of the rapid growth in spending. For example, the authorities might consider what scope existed for de-indexing public sector pay and pensions. As for revenue, perhaps there was scope for reforming indirect taxes; he recognized that any increase in revenue from direct taxation would depend upon reducing erosion.

On wages and prices, Mr. Clark said, without a reform of the scala mobile, it would be hard to reduce inflation. Regrettably, the staff suggested that the 10 percent inflation target for 1984 was unlikely to be met. As in the past, his authorities supported the staff's recommendation that terms of trade and indirect tax effects should be excluded from the scala mobile index.

As to monetary policy, the Bank of Italy had been fighting a valiant battle, but it would perhaps eventually be a losing one so long as the large public sector borrowing requirement persisted, Mr. Clark went on. He nevertheless welcomed the recent moves toward more market-oriented means of monetary control. Under current circumstances, he agreed that there was certainly no justification for a relaxation of monetary policy, and also that higher real interest rates might be necessary, at least in the short term. In that respect, recent calculations by the OECD suggested that real interest rates in Italy were lower than in other major countries. Over the longer term, however, the authorities should aim at creating the conditions that would facilitate a decline in real interest rates by curbing the demands imposed by the public sector on the country's savings.

Recent improvements in the current account were welcome, but they seemed to be largely the result of demand deflation and an improvement in the terms of trade, Mr. Clark remarked. A sustainable improvement needed to be built upon improved external competitiveness. It was disappointing that trade matters were not treated more fully in the staff papers. For instance, he would be interested in knowing to what extent Italy's exports consisted of low-technology goods, which were vulnerable to competition from developing countries, rather than intermediate-technology goods, in which Italy's market share had fallen in the decade before 1980. The authorities should apply a more liberal trade policy.

At times of currency realignment, the authorities had in the past used the wider bands for the lira within the EMS to offset part of the inflation differential between Italy and the other members, Mr. Clark said; that differential had recently widened. The authorities' approach raised the question whether Italian policy was fully consistent with the pledge made by the seven countries participating in the economic summit meeting to promote convergence. He could go along with the staff recommendation against continued approval of the restrictions on foreign exchange for tourist travel, and he urged the authorities to honor their recent commitment to move to a system whereby all transactions would be permitted, with the exception of specific ones requiring authorization.

It had been claimed, Mr. Clark concluded, that the so-called black economy in Italy operated in a more efficient manner than the economy based on recorded activities and had come through the recession in better shape. He found it hard to be altogether comforted by that observation. The very size of the black economy indicated the extent of the distortions in the recorded economy.

Mr. Suraisry expressed agreement with the staff proposals and endorsed the principal points in the staff appraisal. The Italian economy continued to face both short-term and structural problems. In the short run, output remained high, but unemployment had risen to 10 percent of the labor force. In the long run, public expenditure and public deficits had continued to rise at a rapid rate, crowding out private investment and undermining growth potential. At the same time, distortions in the economy had led to rising unit labor costs and growing unemployment, while the country's competitiveness had steadily deteriorated. As the staff had pointed out, those conditions did not represent the best basis for sustained expansion over the medium term. Even on the most favorable assumptions, prospects for 1984 were not encouraging. There was also a real risk that inflationary pressures would intensify and that the current account would weaken. He therefore agreed with the staff on the need for a consistent and complementary set of measures on fiscal, incomes, and monetary policy. The most pressing task was to reduce public expenditure. It was particularly worrying that much of that expenditure was automatic, unproductive, and geared toward consumption rather than investment. The rapid rise in interest payments on public sector debt was particularly striking. Although the measures proposed in the 1984 budget represented a step in the right direction, it was not certain whether they would be fully implemented. The authorities should therefore make every effort to introduce constraints on spending as soon as possible.

Fiscal restraint would have to be the main priority, Mr. Suraisry went on, but it would be effective only if it were supported by a firm incomes policy. A combination of fiscal restraint and wage moderation would help to ease the pressure on monetary policy, which had borne most of the burden of adjustment in recent years. There appeared to be little or no scope for easing monetary policy. The authorities deserved commendation for their successful efforts at financing the deficit by nonmonetary means and for the decision to phase out costly administrative controls on bank lending.

Given the recent deterioration in Italy's competitive position, the high degree of protection and the large subsidies given to ailing industries were disappointing, Mr. Suraisry concluded. As his chair had said on previous occasions, protection was not a lasting solution to structural problems. In Italy, there was a clear need for a comprehensive medium-term strategy aimed at restructuring industry, retraining employees, and assuring greater mobility of labor. He hoped that the 1983-86 investment plan would provide the appropriate framework for such a strategy. Finally, he commended the authorities for their determination to raise the share of ODA in relation to GDP for some years to come.

Mr. Hirao recalled that the Italian economy had continued to experience difficulties in 1983. The adverse effects of the second oil price rise and the sharp expansion of domestic demand in 1979 and 1980 had still not been reversed; the authorities' success in adjusting appeared limited compared with that achieved in Italy's main trading partners. Nevertheless, the latest available data pointed to an imminent recovery, a deceleration of wage and price increases, and an improvement in the external accounts.

As Mr. Lovato had noted, the state of public finances presented serious problems in Italy, Mr. Hirao continued. The excessive expansion of spending apparently reflected what the staff had called "the automatic expenditure-generating mechanisms," which included the indexation schemes for pensions and civil servants' wages. The sharp growth of interest payments was another reason for concern. On the revenue side, the personal income tax continued to account for a large proportion of receipts. Increases in indirect taxes and in charges for public services had been held down because of the authorities' concern about the possible impact of such increases on the scala mobile. The scope for expanding taxation of personal income appeared increasingly limited. Italy's ratio of public debt to GDP had risen by about 24 percentage points in the previous ten years, a shift comparable only to that in Japan, where the ratio had risen from 7 percent in 1973 to 40 percent in 1983. The scenarios for medium-term developments in the Italian public sector were also quite telling; even the most favorable scenario pointed to the urgency of the need to reduce public sector deficits. It would be helpful if the staff could provide an analysis of the fiscal deficit problem in an international framework and in a medium-term perspective for all countries in which the staff found that the problem of the fiscal deficit warranted serious attention, whether by the authorities or by the international community.

He welcomed the new initiatives taken in the 1984 budget and hoped that they would have an appreciable impact on the state sector deficit, thereby reversing the current trend of expansion relative to GDP, Mr. Hirao remarked. A realistic and sustainable medium-term plan, rather than ad hoc measures, was required to tackle the wide-ranging factors responsible for the current fiscal deterioration, including welfare payments and transfers to local authorities.

On monetary policy, Mr. Hirao went on, he welcomed the authorities' shift toward greater reliance on market instruments rather than on administrative directives. On wage policies, the authorities' success in securing the consensus of the social partners for modifying the indexation mechanism, in order to ensure that the growth of labor costs in 1984 did not exceed the inflation target, should have a beneficial impact on public finances. He hoped that the recently begun talks between the social partners would produce positive results at the earliest opportunity. He also thought that the authorities should take specific measures to isolate the indexation mechanisms from effects due to changes in the terms of trade and indirect taxes. Early implementation of the proposed reform of the Wage Supplementation Fund would also be helpful in restoring its original function as a short-term cushion against cyclical fluctuations in employment.

Finally, he shared the staff's concern that the authorities had taken no significant steps to reduce existing trade barriers and, indeed, in some areas had intensified protection, Mr. Hirao said. Like other Directors and the staff, he hoped that the authorities would do more to promote a liberal trade policy.

Mr. Polak suggested that rarely had the staff been as critical about the policies of an industrial country as in the consultation report on Italy. The staff was correct: the authorities had failed to make use of *the recent three-year recession to rid themselves of persistent inflation.* As Table 56 in SM/84/10 showed, Italy had entered a phase of rapidly accelerating interest costs on its public debt; every postponement of adjustment in the budget would make the degree of necessary adjustment that much larger in the future.

In his statement, Mr. Polak went on, Mr. Lovato had said that the staff's scenarios did not account for the reduction in the inflation rate that was likely to follow from an incomes policy pact. The contribution of such a pact might well be small, and only with a declining deficit could monetary policy become sufficiently restrictive to make incomes policies work. Furthermore, recent experience had shown that rapid slowdowns in the rate of inflation were seldom followed soon by corresponding falls in nominal interest rates, so that, for some time, real interest rates often rose. The scenarios presented by the staff did not take that possibility into account either. On balance, the staff's scenarios did suggest the order of magnitude for the required fiscal adjustment, but the recent favorable adjustments in the fiscal field were quite small compared with what was needed. He therefore emphatically supported the view of the staff that the authorities should urgently tighten fiscal policy further.

Although he supported the staff's view on the desirable structural improvements in the scala mobile, Mr. Polak continued, it should be noted that the negative effect of the scala mobile on the share of profits in national income had mainly been felt in the first half of the 1970s. That development was not acknowledged in the trend line drawn in Chart 4 on page 8a of SM/83/269. He had also noted from Table 14 on page 30 of SM/84/10 that the scala mobile alone would not have prevented real income per employee from falling by 20 percent during the previous four years.

The rate of monetary expansion had regrettably remained high, Mr. Polak noted. Notwithstanding the large fiscal deficit and the high rate of wage increases, he was happy to note that monetary financing of the fiscal deficit had decreased. That decrease might well be related to the 1981 separation of the Treasury from the Banco d'Italia.

Temporary improvements in the current account of the balance of payments, mainly as a result of a 4 percent fall in domestic demand during 1983 in comparison with the weighted average of Italy's main trading partners, presented the country with an opportunity to break the vicious circle of inflation and depreciation, because it would allow some increase in the real exchange rate, Mr. Polak went on. Too large a fall in competitiveness should however be avoided, something that required a noticeable decline in inflation. Notwithstanding the appreciation of the U.S. dollar, Italy was one of the few European countries to have experienced a decline in competitiveness. However, the figures on inflation suggested that the effort to interrupt the vicious circle might be in danger of failing. Unless the temporary relief given by recent developments in the balance of payments were used to secure a large reduction in the rate of inflation and wage increases--estimated at 15 percent in 1983, by far the highest rate of all EMS members--the discipline of the EMS would no longer serve to contain inflationary pressures.

Mr. Tvedt observed that, as stated by other Executive Directors, the Italian authorities faced serious difficulties in most fields of economic policy. In particular, the outlook for government finances was not bright. However, he had been glad to learn from Mr. Lovato that the authorities were ready to deal with the problems and that a consensus for fiscal restraint was emerging.

Monetary policy had played a key role in keeping domestic demand under control, Mr. Tvedt recalled. The authorities should not, however, rely too long on squeezing the money supply to maintain internal balance, because they might put undue restraints on the ability of enterprises to renew productive capacity. The intended gradual change from the present administered monetary system toward a more market-oriented one would contribute to alleviating the country's internal problems and eventually its external ones as well, since it would help the authorities to dismantle the complicated foreign exchange regulations currently in place.

In light of the need for breaking the link between wages and past inflation, an incomes policy would be crucial to the authorities' stabilization efforts, Mr. Tvedt continued. He hoped that Mr. Lovato was correct in predicting that a tripartite agreement aimed at improving the trade-off between inflation and unemployment would be concluded in the near future.

At present, Italy's external balance appeared to be satisfactory, Mr. Tvedt noted. Against that background, he had been concerned by Mr. Lovato's reference to an improved international environment as a prerequisite for more liberal trade policies in Italy. In view of the authorities' commitment to an open trade and payments system, they ought to have been able to make some progress.

Mr. Camara observed that the major problem facing the Italian economy was the high budget deficit, which had increased the borrowing requirement of the public sector, thereby crowding out private investors. As timely and decisive corrective action was required, he welcomed the efforts being made by the authorities to overcome their economic difficulties.

However, with the budget deficit expected to be as high as 15 percent of GDP in 1984, additional measures were clearly needed. The authorities had to find means to bring public sector spending under control; they should promptly review the present wage indexation system with a view to containing the growth in labor costs.

Despite Italy's economic difficulties, the authorities had continued to increase official development assistance, Mr. Camara noted. On behalf of his authorities, he congratulated them for their efforts to secure those increases. He hoped that Italy's ODA would continue to increase in the future, in keeping with the authorities' intention to reach the UN target of 0.7 percent of GDP by the end of the 1980s.

Mr. Orleans-Lindsay commented that the Italian economy had experienced a mixture of progress, stagnation, and slippage. That far from satisfactory performance seemed to have arisen largely from the inability of the authorities to take decisive measures to solve their major problems, namely, the excessive growth in public expenditure and attendant budget deficits, together with the income determination mechanism. He shared the concerns expressed by the staff about the economy and endorsed the measures suggested for correcting the persistent imbalances.

The downturn in economic activity in Italy in 1981 had not yet been reversed, Mr. Orleans-Lindsay noted; a decline in GDP of 0.3 percent in 1982 had been followed by a further decline of about 2 percent in 1983. Total domestic demand had continued to be weak, reflecting a fall in private consumption and a reduction in investment attributable to high real interest rates, underutilization of industrial capacity, and diminished profit margins. In 1983, because of uncertainty about employment prospects, households had drawn down savings in an attempt to maintain consumption at a time of declining disposable incomes. Meanwhile, the unemployment rate had continued to increase to the highest point in over 20 years. Productivity had continued to decline.

The weakness in fiscal performance constituted a major problem for the Italian authorities, as they themselves had acknowledged, Mr. Orleans-Lindsay said. The sharp rise in the ratio of the budget deficit to GDP from 13 percent in 1981 to 17 percent in 1983 was a matter for concern, especially as there was little scope for increasing revenue, given the already heavy tax burden. The brunt of adjustment had had therefore to be borne by monetary policy, which the authorities had tightened despite the growing fiscal imbalances. It was encouraging to learn that the Italian authorities had decided to contain expenditure growth in 1984 by cutting back current outlays for social security and insurance. In view of the existing heavy tax burden, he found it hard to believe that they could carry out any increases in direct or indirect taxes. Therefore, they should direct their efforts at making tax enforcement more effective and at widening the tax base.

The authorities had been able to bring down the rate of inflation to 15 percent in 1983 from 19 percent in 1981, Mr. Orleans-Lindsay noted. A greater adjustment effort was needed to narrow the difference between the rates of inflation in Italy and in its trading partners. He shared the staff's assessment that an effective policy of wage moderation, which ought to result in a deceleration of costs and prices, would make it easier to improve Italy's public finances.

There had also been some favorable results in the external sector, Mr. Orleans-Lindsay considered. An expansion in world demand, while trading activity had remained relatively slack in Italy, had resulted in an improvement of the current account, which was approaching balance or perhaps even moving into surplus. He was doubtful, however, whether that modest improvement would continue in the future. He had been pleased to note from Mr. Lovato's statement that the authorities had renewed their commitment to maintaining an open trade and payments system, and that they intended to adopt more liberal trade policies as soon as the international environment improved. Finally, the authorities were to be commended for maintaining a high ratio of official development assistance despite their financial problems.

Mr. Ismael observed that the recently released figures on trade flows presented by Mr. Lovato indicated that Italy had achieved substantial progress in improving its external account in 1983. It was encouraging to note a significant increase in exports accompanied by a moderate growth of imports and a return of reserves to the comfortable level of 1981. Nonetheless, he shared the concern of the staff and previous speakers that the authorities had still fallen short of restoring the necessary conditions for sustainable growth after three years of economic recession with declines in both output and employment. The economy was still plagued by relatively high inflation, sticky interest rates, and declining productivity and competitiveness.

Large public sector deficits, resulting from the excessive growth in expenditure without any corresponding growth in revenue, lay at the center of Italy's economic problems, Mr. Ismael suggested. The consequent growth in public debt had crowded out private sector investment, put upward pressure on inflation and interest rates, and reduced the productivity of the economy. Although the growing consensus for fiscal restraint in political, managerial, and academic circles was a welcome development, he agreed with the staff's warning that the measures taken thus far by the authorities might be inadequate and that some slippage might occur in the targets for raising revenue, restoring competitiveness, and curbing inflation. Thus, it was crucial for the authorities to moderate increases in labor costs by reducing the degree of indexation. He was sympathetic with the authorities' view that an incomes policy could help to reduce inflation and eventually lead to a decline in interest rates and a shrinking public sector deficit. The tripartite agreement reached in 1983 represented an important step in that direction, but he agreed with the staff that a consensus needed to be reached immediately on what proportion of the targeted inflation rate would be paid under the scala mobile system in 1984.

He had been glad to learn that Italy's loss of competitiveness through the exchange rate had been confined to the early part of 1983, Mr. Ismael concluded. In view of the significant appreciation of the lira recorded over the past two years, however, more flexible management of the exchange rate should contribute significantly to restoring Italy's competitiveness. Finally, he welcomed the authorities' intention to overhaul the existing half-regulated system of international payments.

Mr. Zhang remarked that, during the previous decade, Italy's growth record had been satisfactory on the whole. The rate of increase in real GDP had been higher than the average for major developed countries, despite large short-term variations. The marked fall in economic activity during the second half of 1982 had continued into 1983 and had turned out to be steeper than generally expected. All the components of domestic demand had weakened, partly because of the effects of restrictive fiscal and monetary policies, and partly because of the delayed signing of the collective wage agreement. Real foreign balances had improved considerably, but the improvement had been insufficient to offset the fall in domestic demand; consequently, real GDP had fallen for the second successive year; unemployment had risen, and real wages had fallen, leading to a large deterioration in household disposable income. The rate of inflation had diminished significantly, and, like other Western European currencies, the lira had depreciated considerably against the U.S. dollar.

Over the previous decade, while Italy had been able to maintain a moderate rate of growth, the system of wage determination and the rising share of GDP taken by the budget deficit had represented problems that the authorities had not effectively solved, Mr. Zhang recalled. The result had been a continuous rapid inflation that in turn had made it possible to postpone or to evade the solution of many problems. In order to avoid uncontrolled slippages, the authorities had been obliged to resort to periodic severely deflationary monetary policies as a way of enforcing short-term demand management.

During the past several years, however, the authorities had gradually changed the emphasis placed on policy objectives, Mr. Zhang said. Although the primary objective remained the short-term stabilization of the budget deficit, wages, prices, and the exchange rate, the authorities were beginning to pay more attention to supply and structural problems and were also attempting to incorporate short-term stabilization measures into a medium-term framework. Unfortunately, recent developments in the budget deficit, wages, prices, and the exchange rate indicated that the unfavorable international environment and the existing institutional framework in Italy made it difficult to carry out measures of policy reform. The authorities should nevertheless continue to pursue the endeavors already begun; otherwise, he would have to agree with the staff's view that the announced target of reducing the budget deficit by 2 percentage points of GDP might not be attained.

Tax increases so far had fallen mainly on wage income, a practice that not only was inequitable but also contributed to further increases in wage demand owing to wage indexation, Mr. Zhang continued. Therefore, the increase in revenue should come from better enforcement of tax collection; to ensure greater equity, the authorities might also find it desirable to raise taxes on some nonwage incomes, which were the main source of tax evasion. Moreover, the curtailment of current expenditure by the Government involved making hard choices among various categories of spending. The authorities might have difficulty in reducing public employees' wages, which were indexed, and in cutting back on many categories of transfer payments, which were legislatively determined. However, he welcomed the intention of the Government to prepare a substantial package of additional measures to be introduced in 1984. He also agreed that the Government should avoid conducting wage settlements that would further enlarge the budget deficit.

If the goals of controlling the budget deficit and slowing down increases in wages and prices were realized, Mr. Zhang concluded, the authorities could gradually and significantly relax monetary policy without producing unfavorable consequences on the balance of payments. They should relax monetary policy in order to stimulate domestic capital formation, which had been falling since 1981. Nonetheless, he was willing to accept the more optimistic analysis presented by Mr. Lovato.

Mr. Abiad noted that Italy had achieved some progress since the previous consultation in combating inflation, strengthening the external sector, and reforming the income-determination mechanism. Reflecting the task of moderating the effect of the large public deficit on liquidity as well as the necessity of stimulating private financial savings, real interest rates had remained high. Given the danger of an inflationary surge, there was little scope for significantly easing the tight monetary policy currently being pursued. The authorities had indicated that there should be no decline in real interest rates in 1984. In fact, high interest rates together with low capacity utilization appeared to have been important factors behind the sharp decline in gross fixed investment, particularly in machinery and equipment. Could the staff comment on the authorities' apparent intention not to allow deficit financing to be reflected fully in tighter private sector credit?

Restraint should focus on fiscal policy, Mr. Abiad considered, all the more so since budget developments in 1983 suggested that fiscal policy had turned out to be considerably less tight than initially foreseen. While the authorities' objective of stabilizing the 1984 deficit at its 1983 level as a percentage of GDP was the first step in the right direction, the staff considered that it would probably be inadequate. On the other hand, the economic outlook paper published by the OECD in December 1983 had said that the draft budget for 1984 retained the ambitious aim of stabilizing the treasury deficit in absolute terms. Perhaps the apparent difference in perception related more to the assumptions about whether the objective could be achieved than to the degree and pace of adjustment required. At any rate, the bulk of the improvement in Italy's budget position would have to derive from a deceleration in the growth of expenditure, given the limited scope for further increases in the tax burden. The staff's simulations of the medium-term evolution of interest payments on public debt suggested that any reduction in spending would have to come from the noninterest part of the budget. A sustained approach to containing the budget deficit, involving difficult institutional changes, would be needed.

The recent reduction in the degree of indexation and the projected shift away from the past rate of inflation and to the targeted rate of inflation represented steps in the right direction, Mr. Abiad remarked. An early agreement among social partners on the shift could, if fully implemented, contribute to moderating the increase in earnings and hence in the growth of unit labor costs. Such an incomes policy could enhance the effectiveness of demand management, contribute to maintaining Italy's external competitiveness, and promote the resumption of productivity growth.

On trade policy, he was encouraged by the authorities' general support for an open multilateral trading system, Mr. Abiad continued, but he was concerned by the lack of action to reduce existing trade barriers; indeed, they had intensified restrictive trade practices in some areas in recent years. Such practices not only had potentially detrimental effects on Italy's adjustment efforts and domestic resource allocation, but were also damaging to the adjustment efforts and growth prospects of many developing countries.

The significant increase in Italy's ODA commitments in 1983 was noteworthy, Mr. Abiad concluded. Particularly in the light of the difficulties facing many recipient developing countries, he hoped that Italy's disbursements in 1983 would match the amounts committed and that the total would increase in coming years.

Mr. Delgadillo said that, despite some encouraging signs, many of the undesirable developments in Italy's economic performance reflected both the weakness of public finances and the pervasive effects of the income-determination mechanism. The overall public sector deficit recorded in 1983 might lead, in the absence of adjustment, to an unstable situation in the next few years. The central problem seemed to lie in the excessive growth of public expenditure, reflecting the authorities' difficulties in resisting pressures for discretionary increases in expenditure as well as the existence of automatic expenditure-generating mechanisms such as the indexation scheme for pensions and civil servants' wages. Perhaps equally important had been the rise in interest payments on public debt, estimated at 9 percent of GNP for 1983, a figure expected to increase further in the future. The size of the fiscal deficit helped to explain the persistence of slow real growth and high inflation, not only because resources were shifted toward less productive sectors, but also because, at a time of relatively tight monetary policy, investment by the private sector was crowded out. As wage increases depended not on productivity but on inflation, labor income had assumed a higher share of total national income, while certain additional pressures had also reduced the competitiveness of enterprises. As the staff had said, there was a clear need for a substantial and sustained improvement in public finances.

At a time when the real exchange rate for the lira had significantly appreciated in real terms, the Italian authorities had adopted more protectionist measures, Mr. Delgadillo said. An appreciation of the lira, if continued, would reduce the scope for further improvements in the performance of the external sector and might trigger additional pressures for increased controls on the payments system, as previous appreciations had done. To forestall such a development, the authorities might consider adopting a set of measures designed to avoid restrictions on free trade. They would thus reduce the costs of the inevitable adjustment, which would be higher if they continued to rely on trade restrictions to deal with structural problems in their own economy.

Mr. Jayawardena expressed broad agreement with the staff papers, which, he hoped, would help the Italian authorities to come to grips with their problems. The staff was to be commended for its simulation of different medium-term scenarios and alternate policy options, which were excellent examples of what the Fund's surveillance function ought to be. He hoped that the practice would be adopted for all major economies.

The Director of the European Department, responding to questions, explained that some figures that appeared alarming in Italy might look less so if the staff were able to quantify the importance of the black economy. The distortions attributable to the unfortunate trade-off between growth and inflation, the tight monetary policy that put an increasing number of firms in difficulty and the reluctance of the Government to allow unemployment to increase, led inexorably to a steady growth of the public sector. The Governor of the Bank of Italy had indicated that, during the first eight months of 1983, the proportion of total domestic credit taken by the state had exceeded 70 percent. By the end of 1983, the Governor had gone on to note, financial assets held by households and firms would be 8 percentage points higher as a proportion of GDP than in 1982. Furthermore, the Governor had observed that the ratio of debt to GDP at the end of 1983 had been approximately 80 percent, against only 60 percent some three years previously.

A suggestion had been made by Mr. Senior and Mr. Blandin that the staff ought to have included in Table 4 of SM/83/269 a middle scenario between the one assuming no adjustment and the one assuming rapid adjustment, the Director continued. The staff had indeed included a scenario of gradual adjustment in Table 58 of SM/84/10.

A request had been made by Mr. Leonard for ideas about how the authorities could increase revenue and cut spending, the Director went on. It should be made clear that the overall ratio of government revenue to GDP in Italy had risen sharply in recent years, having reached over 40 percent in 1983. Some countries in Europe had a yet higher percentage, and they were not without their difficulties as a consequence. In trying to enhance revenue, the Italian authorities could surely seek to reduce tax evasion, an area in which it was possible to make further progress. The staff believed that an increase in public sector tariffs and the imposition of a property tax by the local authorities should also be considered.

Negotiations were currently taking place on Italy's incomes policy, the Director noted, and little could be added to what the staff had said on the subject. The risk was that too high a share of any settlement might be borne by implicit or explicit agreements on public sector tariffs or the holding down of taxes. There was also the risk that any settlement that eventually emerged would do nothing to improve the compression of wage differentials, which had been a weakness in Italy during the previous several years.

In response to Mr. Templeman's question on Italy's competitiveness, the index of relative wholesale prices in manufacturing had shown a 3 percent increase in 1983 compared with 1982, but it had shown no change in the course of 1983, the Director observed. When the comparison was based on the relative behavior of unit labor costs expressed in U.S. dollars, the deterioration appeared noticeably larger. It was probably associated with the fall in productivity in Italy that had occurred during 1983.

A comment had been made by Mr. Lovato about a possible inconsistency between the economic upturn in 1983 and the economic measures currently in force, the Director noted. The comment seemed to show the importance of the underground economy, but it was not at all clear to the staff or to the Italian authorities that the underground economy had in fact been expanding. Indeed, the conventional wisdom in Italian circles was that it had recently been shrinking. By definition, the size of the underground economy was hardly susceptible to accurate measurement. In addition, there were different interpretations of what the term encompassed. An article in the Wall Street Journal had indicated that, in Peru, black activities were considered to be illegal activities in the sense of not conforming to licensing regulations. The staff, however, tended to regard the black economy of a country as being made up of all forms of activity that distorted economic statistics, a point suggested by Mr. Blandin. He himself presumed that the statistics least affected by the black economy in Italy were those on credit and the balance of payments, while the figures most affected were surely those for national income, output, unemployment, and social security receipts.

In the light of Mr. Blandin's comment that it would be useful to have data on the public sector that reached further back into the past, the Director said that such data were furnished in the tables beginning on page 45 of SM/84/10, particularly Table 21. Mr. Blandin was correct in noting a sharp fall in Italian exports to developed countries in the first half of 1983. The fall should be contrasted with the rapid growth that had previously taken place. Shifts in exchange rates provided part of the explanation for those differences. In any event, the most recent provisional information indicated that Italian exports had performed noticeably better during the second half of 1983.

The comment by Mr. Clark that the staff should have provided more of a breakdown of trade was well taken, the Director commented. The staff had attempted to analyze selected indicators of trade performance in SM/84/10, from page 80a on.

Some similarities, but also great dissimilarities, in the performance of the Japanese and the Italian economies had been remarked upon by Mr. Hirao, the Director of the European Department concluded. The staff had also been struck by some of the similarities, as Japan and Italy shared the distinction of having extremely high levels of gross private sector savings for industrial countries, varying between 25 percent and 30 percent; however, the use made of those savings differed markedly between the two countries. Private savings in Japan were able to finance a much higher level of investment in relation to GDP than in Italy, where they were offset by drawings of the public sector.

Mr. Lovato observed that Executive Directors had suggested that the Italian authorities should accelerate the adjustment process by tackling the fundamentals without delay and, in particular, by reducing the public sector deficit and containing labor costs. There remained the problem of reaching consensus, which was particularly complex in Italy, mainly because solutions to the country's problems required not only changes of attitude, but also changes of laws, and even of the constitution. As the staff had said, the roots of the fiscal problem on the expenditure side had been the creation over time of automatic expenditure-generating mechanisms such as indexation schemes for pensions and civil servants' wages, the decentralization of spending decisions without a corresponding decentralization of revenue-raising responsibilities, and finally the inability of successive governments to resist pressures for discretionary increases in spending. The explanation accounted not only for the causes of Italy's present predicament but also for the difficulties faced by the authorities in overcoming it.

Admittedly, Mr. Lovato continued, many rigidities remained, but the atmosphere had changed. Some major industries had returned to profitability; even within the state industrial group, there were clear signs of greater emphasis on efficiency and productivity. Small and medium-sized enterprises had adapted quickly, thus demonstrating the vitality of the economy. In fact, the Italian economy was stronger than it appeared from the figures. Labor unions had accepted a review of the indexation system, partly because of the recession, but also because their members no longer wished to accept schemes of wage adjustment that did not distribute rewards according to productivity. The authorities' monetary stance had been restrictive, while interest rates had remained positive in real terms, being comparable to those in other countries. According to the Governor of the Bank of Italy, until the necessary decisions were taken in connection with the budget and incomes policy, monetary policy would remain flexible, but not accommodating. The authorities believed that their experience with the European Monetary System had been positive. It had brought relative stability to the real effective exchange rate, implying a loss of competitiveness, but it had also contributed to reducing inflation and improving productivity.

Like the staff, his authorities considered public finance to be the area of greatest concern, Mr. Lovato remarked. The difficulty was that redressing structural imbalances required comprehensive adjustment measures, the adoption of which presupposed a stronger government. Normally, governments in Italy were not strong enough to pursue their own objectives with firmness; the new Government had done everything possible under the circumstances. The authorities found it difficult to make substantial reductions in public sector spending in the short term, especially since budget preparation was extremely sensitive to international cyclical factors. The previous year, for example, the larger than expected fall in economic activity had negatively affected tax receipts and had boosted transfer payments owing to unemployment. He agreed that, in the absence of corrective measures, the public sector deficit would grow further both in absolute terms and in relation to GDP. Nevertheless, all projections forecast an increase in output, which, together with lowered inflation, should produce a better result than appeared likely at present. The Italian Parliament had approved the 1984 budget on time, providing for some cuts in pensions, social security, and public health care. The Treasury Ministry intended to stick to its original target. Executive Directors should accept the reality that changing the structural causes of the public sector deficit would be a long-lasting process, and that what mattered was that the trend of the previous few years had been reversed.

An impending recovery in real demand and output, together with a deceleration in wage and price increases, was likely to produce a marked improvement in the external accounts, Mr. Lovato observed. That was just the trend that the Government was looking for, and its fiscal and incomes policy should help to put the cycle in motion. The increase in revenue owing to the recovery, together with cuts in public spending and slower wage increases, should bring down the inflation rate further. Many economists also believed that the decline in nominal interest rates, in line with declining inflation, should enable the Government's interest payments to fall significantly. After all, about 60 percent of public sector debt was short term or at variable interest rates; interest payments currently represented about half of expenditure.

As for trade policy, Italy had one of the most open economies in the world, Mr. Lovato commented. The authorities were committed to maintaining an open trade and payments system, convinced as they were that such a system was best for everyone. The restrictions recently adopted had been inspired by the recession, by difficulties in certain specific sectors, and by prospects of higher unemployment. They were intended to be temporary. Italy's balance of trade remained structurally negative, but the deficit should disappear if the current account balance improved sufficiently.

In conclusion, he would like to reiterate the points stressed by the staff on page 8 of SM/83/269 that the Italian authorities were fully aware of the costs that the steady deterioration in public finances had entailed for economic performance and also for the urgent need to reverse that trend, Mr. Lovato noted. In the past, the Italian economy had demonstrated enough flexibility to absorb international shocks and to overcome many domestic problems, despite a number of institutional shortcomings in the social and economic structures. At present, households had increased their confidence and, apart from maintaining a high propensity to save, were moving assets from real goods to financing investment and securities with longer maturities. He hoped that those favorable trends would continue.

The Chairman made the following summing up:

Executive Directors welcomed the improvement in the external accounts and in the inflation performance of the Italian economy during 1983 but noted that much of this improvement had reflected favorable external influences and relatively depressed domestic demand. They also noted that Italy's inflation rate remained about twice as large as that of its main trading partners. They expressed concern that a revival of domestic activity could lead to renewed pressure on inflation and the balance of payments unless rapid progress were made in the long-standing areas of weakness of the economy, especially the public finances and the wage determination mechanism.

Directors expressed concern about the continuing high rate of increase in labor costs in 1983. They, therefore, welcomed current efforts of the Government to secure agreement by the social partners to a modification of the wage indexation mechanism that would allow the containment of labor costs to the target rate of inflation in 1984; but they cautioned that such an agreement should not be obtained at the price of a further increase in the public sector deficit.

There was widespread agreement that the sharp increase in the public deficit and in public expenditures relative to GDP in recent years had contributed to worsening the trade-off between growth and inflation in Italy and that, therefore, high priority should be attached to securing a significant and rapid reduction in the public deficit in relation to GDP in 1984 and beyond. Given the inherent dynamics of interest payments on the public debt, which constituted an exceptionally heavy burden on the budget, this objective would require substantial efforts to contain and curtail noninterest expenditures--including social transfers as well as the rapidly rising transfers to public sector enterprises--to broaden the tax base, and to improve tax enforcement. Directors urged the Italian authorities to review the budget prospects for 1984 in the near future and to put in place measures adequate to secure the containment of the state sector's deficit to, at most, the same absolute level as in 1983.

Directors welcomed the increasing reliance by the monetary authorities on market mechanisms in the control of the monetary aggregates and urged the authorities to continue a flexible management of interest rates with a view to containing the impact of the public sector deficit on the monetary base by securing the absorption by the nonbank public sector of a rising share of the financial assets created by the deficit.

Directors welcomed the recent liberalization of capital controls and urged the authorities to move promptly toward eliminating the restriction on the allowance for tourist travel.

They also urged the authorities to take advantage of the improvement in the balance of payments to reduce reliance on trade restrictions and to promote the necessary adjustments in sectors in difficulty. In this respect, Directors expressed concern about the real effective appreciation of the exchange rate. They stressed the importance of maintaining a degree of flexibility in exchange rate policy and avoiding losses of competitiveness.

In all, while recognizing the remarkable resilience of the Italian economy, Directors were concerned to note that, in their view, the authorities had not been able, in recent years, to deal as effectively as was needed with the basic problems of the economy, consequently increasing the risk that structural problems and distortions will continue to grow. The pre-emption of resources by the public sector and the continued excessive increases in labor costs carried the danger of reducing Italy's growth potential. Further postponement of the needed adjustments would only exacerbate the necessary task.

Directors welcomed the increase in ODA commitments relative to GDP that was planned for 1984.

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

4. SURINAME - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with Suriname (SM/84/6, 1/5/84). They also had before them a report on recent economic developments in Suriname (SM/84/18, 1/16/84).

Mr. Kafka made the following statement:

There has recently been a change in government in Suriname, and the new ministers are to take office in a few days. The outgoing Minister of Economy has assured me that there will be no change in policies from those that would have been pursued by the present authorities, and he was strongly of the opinion that the consultation should go ahead as planned.

The authorities agree with much of the staff report, although they have reservations on some important aspects of it. Basically, however, they consider the report an objective reflection of the situation that the mission found at the time of its visit.

Since the second oil shock, the bauxite industry and therefore the entire Surinamese economy, which is so heavily dependent on exported bauxite and imported oil, have been damaged by deteriorating world market conditions. Domestic investment as well as real consumption fell in every recent year except 1980 and 1981. On the other hand, the rate of increase of consumer prices has been declining steadily since 1979 and the implicit GDP deflator since 1980; in 1983, the rate of inflation, however measured, was decidedly very low by international standards. The fall in imports was due not only to restrictions but also to the depressed state of the economy as a result of the bauxite crisis. The deterioration of the fiscal situation and the increase in monetary expansion reflected the impact of the bauxite market and general world economic recession.

While the bauxite market is expected to improve in 1984, the major uncertainty affecting the outlook in Suriname is the indefinite suspension of the disbursement of the Dutch grant. If disbursements were resumed, Suriname's reserve position and balance of payments situation would improve dramatically; the availability of the grant would have reduced the 1983 current account deficit by almost two thirds, while the overall payments balance would have been close to equilibrium.

The plans of the Government, as explained to the mission, go a long way in the direction of re-establishing internal and external equilibrium as early as 1984. The authorites foresaw a sharp fall in the public sector deficit compared with 1983, about equally divided between expenditure cuts and tax increases. Some of the latter appear to have recently been suspended or compensated in part by interest-free loans, and it remains to be seen what offsetting measures the Government will adopt, if necessary. It is particularly welcome that the Government should have decreed a freeze on new hiring with only modest adjustments in the overall wage bill, well below price increases. At the same time, the Government, avoiding the mistake committed by many other countries in a similar situation, has foreseen larger adjustments for the upper grades of civil servants to avoid their leaving employment or even Suriname.

Finally, the Government has informed me that it considers the size of the investment program to be entirely dependent on its ability to obtain resumption of disbursement of the Dutch grant or on borrowing from the commercial market. The latter, however, is conceived either as a bridging operation before resumption of the Dutch grant or as a relatively modest operation that will be compatible with the social productivity of the development expenditures to be financed. Since Suriname is in the enviable position of having a foreign debt of 2 percent of GDP and a negligible debt service ratio, the staff's fears of Suriname's borrowing for development purposes up to 8 percent of GDP this year, provided that such sums could be obtained on acceptable terms, seem vastly exaggerated because there is no expectation that such a rate of borrowing is to continue year after year. Suriname may borrow, in addition, to increase its reserves, but with its very low net debt that possibility also seems entirely reasonable and would obviate the need for running a current account surplus to increase net reserves.

Still in respect of demand policy, my Surinamese authorities expect to adopt a careful monetary policy in which they will be helped by the contemplated drastic reduction of the public sector deficit. They are increasingly convinced that they would allow interest rates with respect to deposits to become positive or possibly to issue a new type of financial instrument.

The main doubt of my Surinamese authorities about the suggestions made by the staff during the mission refers to foreign trade and payments. As already indicated in the report, the authorities have genuine doubts about the appropriateness of a devaluation of the currency at this time. They do not, however, exclude such a possibility. Their arguments are not presented fully in the staff report. They feel that, in addition to bauxite, the second major export product, rice, would be unlikely to benefit from a devaluation because, even at the present exchange rate, local costs are sufficiently low to make Surinamese rice competitive in export markets. As for nontraditional exports, they feel that possible long-term effects are too uncertain, and that priority must be given to dealing with the urgent short-term problems; an exchange rate change would be too dangerous in terms of unleashing wage pressures at this time. On the import side, as the staff mentions, the authorities prefer to use selective tariffs in order to combine a disincentive to imports with stimulation of particular import substitutes, but they have indicated to me that they would be prepared seriously to consider using excise taxes rather than tariffs where no protective effect was intended.

On the question of restrictions, I believe that the staff is somewhat mistaken in interpreting the intentions of the Surinamese authorities. They have no intention of making restrictions or multiple rates a permanent feature of the Surinamese economy. They are, however, caught by a fall in reserves, and they want to be absolutely sure before abolishing the restrictions that this fall has been stopped and that there is no danger of its resuming despite adoption of the appropriate macroeconomic policies. To my mind, such an attitude characterizes the intention of using restrictions only temporarily, but perhaps at some time the Board will face up to the problem of giving the staff guidance on what is temporary and what is permanent. I also feel that the staff is going much too far in expressing fears that existing restrictions and possibly others that may be introduced temporarily before the macroeconomic policies take hold would perpetuate and aggravate, to use the staff's expression, distortions in the economy; since restrictions are temporary, that is unlikely to happen. The same is true of the staff's comment regarding bilateral agreements that they "entailed serious disadvantages while, at best, providing only temporary relief," because these agreements, insofar as they are distortive, are not intended to be anything more than temporary.

Finally, on development strategies, the Surinamese authorities have in my opinion been well advised to abandon the excessive expenditures at one time contemplated for the Kabalebo project, under which bauxite mining was to be developed in the west of the country by use of almost the entire remaining Dutch grant. This would not have been an investment that would have contributed to the stimulation of employment in Suriname because it would have been heavily capital intensive, nor would it have tended to improve the balance of the economy between bauxite and other exports or between promotion of exports and efficient import substitution, particularly in agriculture and smaller industries.

Mr. Delgadillo noted that, given the difficult international environment, especially the weakening in the world bauxite market and the uncertainties concerning the resumption of aid from the Netherlands, the Surinamese authorities faced a difficult task in reversing the deterioration in economic performance. GNP had declined markedly in 1983. Public sector finances had worsened, with the overall public sector deficit reaching 15 percent of GNP, a development that helped to explain the deterioration in the current account. The drastic reduction in foreign capital inflows had been almost entirely attributable to the virtual disappearance of public grants, which had led to an unsustainable balance of payments deficit.

He welcomed the authorities' intention to re-establish internal and external equilibrium, Mr. Delgadillo went on. They should be commended for attempting to reduce the public sector deficit by cutting expenditures, increasing taxes, and containing increases in the overall wage bill. Action taken on public finances should facilitate the tightening of monetary policy. He also welcomed the authorities' intention to allow positive interest rates at a time when they had become important in order to forestall capital outflows.

The explanations provided by Mr. Kafka of Suriname's exchange rate and trade policies were quite clear, Mr. Delgadillo noted. The restrictions on trade and the imposition of multiple exchange rates were not conceived as permanent features of the authorities' external policies. He understood the restrictions, tariffs, and multiple rates as attempts to minimize the need for more direct action in fiscal, monetary, and exchange rate policies.

Perhaps, under an arrangement with the Fund, Suriname's temporary use of external resources, combined with the more ambitious monetary and fiscal program, could achieve the same improvement in the external situation without increasing the cost of adjustment, Mr. Delgadillo suggested. Perhaps, indeed, the temporary use of external resources would facilitate the prompt elimination of those policies that had proved detrimental to the growth of the economy.

Suriname faced difficult circumstances that would require major sacrifices, Mr. Delgadillo concluded. The authorities were to be commended for their willingness to act decisively in the main policy areas under their control. The Fund should stand ready to support an accelerated program of adjustment if the authorities requested one and chose to speed up adjustment.

Mr. Polak commented that Suriname was experiencing a time of uncertainty, both politically and economically. The previous Government had resigned two months previously, and expectations that a new cabinet would take office on the present date had not been fulfilled. The intention had been to create a small cabinet that, over a six-month period, would seek solutions to the immediate political and economic difficulties of the country.

Unless drastic measures were taken, Suriname's foreign exchange reserves might well be depleted by the middle of 1984, Mr. Polak noted. Given the country's limited ability to borrow, payments for goods from abroad would grind to a halt. It was therefore essential that a program covering all aspects of macroeconomic policy should be installed soon, to supplement the partial measures already taken. He concurred with the staff that the authorities should assign the highest priority to reducing the budget deficit. Unfortunately, the budget situation had deteriorated since the staff visit in October, as a result of a five-week work stoppage in the bauxite sector. More stringent actions than those foreseen several months previously had become necessary; as Mr. Kafka had noted, it remained to be seen whether they would be forthcoming. The severe difficulties experienced in fostering public support for the authorities' measures cast doubt on the feasibility of the aim to reduce imbalances drastically in 1984. Nevertheless, another reason for making severe reductions in the deficit would be to restore the traditional role of the Central Bank, which was providing large-scale credit to the public sector. In 1983 alone, the share of claims on the Government by the Central Bank had risen from 20 percent to 40 percent of total assets.

Fiscal tightening should not be the only instrument used by the authorities, Mr. Polak suggested. For example, a more active interest rate policy should also have a place in a comprehensive package of adjustment. Interest rates on savings and time deposits had been kept unchanged for many years. Higher rates could contribute significantly to raising growth in private sector savings, which had fallen greatly during the past year. Major changes would also be required in the monetary system. At present, the banking system was very liquid; the authorities would have to absorb that liquidity.

On the external side, cracks had appeared in the two pillars of Suriname's foreign exchange earnings, bauxite and foreign aid, which together accounted for 60 percent of Suriname's income from abroad in 1982, Mr. Polak remarked. Regrettably, the alumina smelter of Suralco, a subsidiary of Alcoa, had been shut down as a result of the work stoppage, and it would be some time before exports could resume on the previous scale. As to the resumption of development assistance from the Netherlands, the Prime Minister of that country had recently stated to Parliament: "Concrete steps would have to be taken toward democracy and a government of laws, including respect for basic human rights, and a structure such as to prevent a repetition of the events of December 1982."

In discussing means of improving Suriname's balance of payments, the staff had paid careful attention to the role of the exchange rate, Mr. Polak observed. The staff had not directly recommended a change in the rate, which would indeed be premature, but had noted indications that the Suriname guilder was overvalued, something that would hinder efforts to generate greater flows of exports. With Mr. Kafka, he agreed that Suriname should not concentrate too large a portion of foreign aid on a large additional bauxite program; the staff noted that alternative projects, mainly in agriculture, had not yet been selected. If devaluation were needed for nontraditional exports, the resulting windfall profits on bauxite could no doubt be dealt with through special measures.

Like the staff, he was concerned about the Surinamese authorities' excessively obstructionist policy with respect to imports, including attempts at bilateralism, and he was also concerned about the distortions and rigidities to which such a policy could lead, Mr. Polak concluded. Mr. Kafka had assured Directors that there was no such risk, since those measures were supposed to be temporary. He hoped that the assurance would prove to be true and that, in the meantime, temporary false signals would be duly ignored. It still remained true, however, that there was an absence of correct signals, and it was urgent for the authorities to put them in place. Looking beyond present difficulties, he found it beyond question that Suriname had great potential and hoped that the authorities would find ways to develop it.

Mr. Erb agreed that fiscal policy had to be based on overall government operations and should take into account the resumption of foreign trade. He had been concerned by the sharp deterioration in the trends that had emerged during 1983, and he urged the authorities to do what was needed to rectify those imbalances as quickly as possible.

With respect to borrowing on commercial terms to support the budget deficit of the Government, Mr. Erb remarked, such borrowing should be undertaken only in the context of a firm commitment to adjust unnecessary measures. It was also desirable to re-evaluate development projects financed by external financial sources. He would urge the authorities to exercise prudence and realism as they pondered the prospects for changes in monetary policy. Given Suriname's relatively high per capita GDP, he agreed that there was clearly scope for increasing domestic savings; appropriate interest rate policies would assure positive real rates of return on domestic financial instruments.

Regarding external policies, he strongly urged the authorities to implement a flexible exchange rate policy as the cornerstone of their adjustment program, Mr. Erb continued. He agreed with the staff's decision to withhold approval of the foreign exchange licensing and the multiple currency practice. A judgment was required by the staff and management of the Fund whether the broader policies being pursued by the authorities would perpetuate or alleviate the underlying imbalances that had given rise to the restrictive practices subject to Fund approval. Should the judgment be that the current policy would perpetuate Suriname's problems, it would be logical to conclude that the restrictive practices would not prove to be temporary and that, therefore, approval by the Fund would be unjustified.

Mr. Zhang noted that, like other countries emerging from colonial status, Suriname faced the task of transforming its economy. The Government had had to play a strategic role in the transformation. Indeed, from late 1970 until independence, the rapid expansion of public outlays had been the most important factor in the high growth rate of real GDP. By contrast, since 1980, unfavorable conditions had triggered an economic slowdown in Suriname. There had been stagnation or high decline in GDP, together with a sharp deterioration in the balance of payments position. The deficit on the external account had more than doubled as a percentage of GDP from 1980 to 1983, so that in 1982 Suriname had registered its first overall balance of payments deficit since 1977. Suspension of disbursements of grants from the Netherlands had been the principal cause of the deficit.

The policy measures planned by the authorities had struck him as realistic and appropriate, Mr. Zhang commented; they ought to be encouraged and supported by the Fund. There were some policy issues on which the views of the staff and the Surinamese authorities had diverged. For example, the staff believed that a devaluation of the Suriname guilder was necessary, while the Surinamese authorities had doubts about the appropriateness of devaluation. Before examining the relevant facts to determine whether devaluation was advisable, Directors should keep in mind that Suriname's exports consisted of only a few commodities and that the composition of exports was quite different from that of domestic demand.

Suriname's main exports consisted of four main groups of commodities, Mr. Zhang continued: bauxite and its derivatives accounted for 75 percent, rice for 8-9 percent, shrimp for about 4 percent, and wood and wood products for about 2.5 percent. Between 1972 and the third quarter of 1982, the prices for rice and shrimp exports had been rising moderately, but those for bauxite and its derivatives as well as for wood and wood products had shown large declines. The decline in the value of bauxite exports had been the result of a world recession. In addition, those exports were controlled by multinational corporations, and prices on the world market were quoted in dollars. A devaluation of the Surinam guilder would thus probably have little effect on exports of those products. As Mr. Kafka had said, Suriname's exports of rice were unlikely to benefit from a devaluation of the guilder, because, even at present exchange rates, domestic costs were sufficiently low to make Suriname's rice exports competitive in international markets. Incidentally, the prices of shrimp were also controlled by multinational companies. Furthermore, had the staff studied actual market-price demands for Surinamese exports of rice, shrimp, wood, and some other nontraditional exports that the staff suggested should be expanded? What were those other nontraditional exports? Moreover, since Suriname was so dependent upon imports for its essential commodities, the rise in domestic prices consequent upon a devaluation would impair future government attempts to contain inflation, which had been quite successful in recent months.

As to the existing restrictions on foreign exchange and trade, the authorities' intention to remove them as soon as possible was commendable, Mr. Zhang observed. Experience had shown that such restrictions might originally be imposed as expedient measures and could eventually help to correct distortions existing in the economy.

In conclusion, given the difficult task facing the Surinamese authorities, in particular at the present time of extreme difficulties, their accomplishments should not be underestimated, Mr. Zhang considered. Instead, the international community should give sympathetic consideration to the economic and financial needs for Suriname's future development and improvements in the people's livelihood.

Mr. Sangare associated himself with the remarks made by Mr. Zhang.

The staff representative from the Exchange and Trade Relations Department noted that it was not entirely correct that the staff had recommended an adjustment of the existing exchange rate of the Suriname guilder. The staff had come away from its examination of available facts with the Surinamese authorities with the strong impression that, indeed, exchange rate action might well be required. Certainly, the staff had the strong impression that adjustment, which would have to focus on the fiscal side, would be made easier if exchange rate action were taken. However, the staff had made it clear to the authorities that it had not yet arrived at a firm view on the matter. The staff had invited the authorities to study the subject in depth, and the staff intended to develop further information as it became available, in an effort to arrive at a firmer view. The first indication that something might have to be done had come from calculations of the effective appreciation of the exchange rate since the time of the previous consultation discussions. Some of the points contained in Mr. Kafka's statement were new to the staff but certainly welcome, particularly the point that the restrictions reported by the staff were expected to be temporary.

Referring to Mr. Zhang's question of how a devaluation could help to improve exports when prices were set on world markets in dollars and when there might not be a vast potential for expansion within the country, the staff representative explained that the bulk of Suriname's current export receipts indeed derived from commodities, the price of which would differ little in the event of a devaluation. At the same time, the staff considered that the Surinamese economy should be geared toward longer-run diversification. In fact, the Government had often announced a development strategy pointing specifically to the need to diversify. Moreover, the allocation of available resources for development projects had been away from those commodities in which the effects of an exchange rate change on prices would not be great. After all, 64 percent of the ongoing projects financed largely by foreign aid had been allocated to agriculture. Some of the agricultural products being promoted in that manner were not entirely free either to respond to exchange rate and price changes--such as items traded through various special arrangements with the European Communities-but there were also commodities that could be considered more flexible in their response to such possible changes. In any event, the potential for the exchange rate to play a role in aiding the expansion of exportable goods was certainly recognized.

Mr. Kafka noted that what he had said on the question of adopting measures to replace the possible suspension of taxes or the cost of interest-free loans had been slightly different from what Mr. Polak had said. He himself had not observed that it remained to be seen whether measures were going to be taken; he personally had no doubt that, if necessary, the authorities would take measures.

On the question of a possible devaluation, Mr. Kafka continued, he would say that, even though the price for a certain commodity was fixed in the world market, devaluation, by lowering costs where they were excessive, could promote exports, but that reasoning did not appear to apply to Suriname. The main commodity liable to improvement was rice, and the costs of rice production were hardly excessive. In addition, the only year in which there had been a fall in exports had been 1982, when the total of exports in Suriname guilders had been smaller than the 1979 figure. Except for the category "other," which included re-exports, Suriname's other exported products had continually risen in value until 1982. From 1982 to 1983, all categories had again climbed, except for wood and wood products. He thus thought that the case for devaluation had not been made, but, as he had said, his authorities would continue to keep an open mind on the matter. Finally, the decline in the value of Suriname's exports of bauxite was attributable to the recession on world markets rather than to any lack of competitiveness in Suriname.

The staff representative from the Exchange and Trade Relations Department added that ominous signs had appeared that some potentially promising areas of exportable products were not doing as well as they could. For instance, there were indications that shrimp harvesting, which was largely dependent upon foreign-owned boats, had been moving to other countries because of cost disadvantages in processing the shrimp, apparently an important consideration for operators of boats fishing in Surinamese waters.

There were many indications that cost considerations could also play a role in the timber industry, the staff representative continued. While it was recognized that transportation and other structural factors played an important role, as they did also in the bauxite industry of Suriname, there was still a strong presumption that changes in relative prices and costs might make a difference in Suriname's total exports, certainly a greater difference in the longer run than in the short run.

The Chairman made the following summing up:

> Directors observed that, in a difficult international economic environment, the imbalances of the Surinamese economy had increased significantly over the past three years. Despite the curtailment of aid inflows and falls in other government revenue, overall government expenditure continued to increase in 1983, resulting in a budget deficit estimated at some 15 percent of GDP. Directors viewed this as unsustainable and urged the Surinamese authorities to adopt without delay a comprehensive stabilization program that should include decisive corrective fiscal action, including a sizable cut in government expenditure.
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> Several Directors expressed concern over the Government's attempts to extend administrative controls over prices, imports, and foreign exchange in order to deal with the demand management problem. To stem the loss of net international reserves, credit expansion by the domestic banking system needed to be curtailed, and this was contingent upon a reduced fiscal deficit. Directors also noted that other measures, such as raising interest rates on deposits, could be instrumental in improving financial savings and easing the pressure on the balance of payments. Having in mind the need to assure Suriname's international competitiveness, Directors advised the authorities to keep under review all factors bearing on it, including the exchange rate.
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> Development expenditure had been reduced by nearly one-half in 1983. Directors cited the need to reduce public sector dissaving to allow a return to higher levels of development spending and, thus, to help promote growth of the economy. In

this context, a more active role for the World Bank in the re-evaluation of the development plan was advocated. Suriname's low external debt was noted, but concern was expressed that future servicing problems might arise if Suriname were to rely unduly on commercial bank financing.

Directors agreed that the next Article IV consultation with Suriname should be held on a 12-month cycle.

APPROVED: July 17, 1984

JOSEPH W. LANG, JR.
Acting Secretary