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# INTERNATIONAL MONETARY FUND

## Minutes of Executive Board Meeting 84/20

10:00 a.m., February 8, 1984

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

| Executive Directors | Alternate Executive Directors |
|---|---|
| | W. B. Tshishimbi |
| | H. G. Schneider |
| | X. Blandin |
| | J. Delgadillo, Temporary |
| R. D. Erb | D. C. Templeman, Temporary |
| | M. Z. M. Qureshi, Temporary |
| | Y. Okubo, Temporary |
| J. E. Ismael | |
| R. K. Joyce | |
| A. Kafka | H. A. Arias, Temporary |
| | G. Grosche |
| | W. Moerke, Temporary |
| | C. P. Caranicas |
| | A. S. Jayawardena |
| | S. El-Khouri, Temporary |
| | T. de Vries |
| | K. G. Morrell |
| | H. Alaoui-Abdallaoui, Temporary |
| | J. A. K. Munthali, Temporary |
| | J. L. Feito |
| J. Tvedt | A. Lindø |
| | T. A. Clark |
| Zhang Z. | Wang E. |

L. Van Houtven, Secretary
S. J. Fennell, Assistant

Also Present

Asian Department: L. Mendras. European Department: L. A. Whittome, Counsellor and Director; P. L. Hedfors, H.-J. Huss, M. Ishihara, A. Knobl, S. Mitra. Exchange and Trade Relations Department: S. Mookerjee, Deputy Director; M. Guitian. External Relations Department: H. P. Puentes. Fiscal Affairs Department: G. Blöndal. Legal Department: J. M. Ogoola. Secretary's Department: A. P. Bhagwat. Western Hemisphere Department: S. T. Beza, Associate Director; A. Baumgarten, Jr., M. E. Bonangelino, D. S. Hoelscher, C.-J. Lindgren. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: K. A. Hansen, L. Ionescu, H.-S. Lee, G. E. L. Nguyen, I. R. Panday, D. I. S. Shaw. Assistants to Executive Directors: I. Angeloni, L. E. J. M. Coene, M. Eran, V. Govindarajan, C. M. Hull, A. K. Juusela, H. Kobayashi, A. Kone, G. W. K. Pickering, Shao Z., J. C. Williams.

1. REPORT BY MANAGING DIRECTOR

The Chairman commented that on February 4, 1984, the first day of his visit to Belgium, he had had lunch in Ghent with Mr. De Clercq, the Interim Committee Chairman, and Mr. Martens, the Prime Minister of Belgium. The following day he had traveled to Liège, where he had had lunch with Mr. Gol, a Vice-Premier of Belgium and the Minister for Justice. Also present at the luncheon had been trade unionists and industrialists; they had held an interesting discussion on the problems of the region and the country. On February 6, he had been received by his Majesty the King. After a long discussion with the King on the policy options currently facing Belgium, he had met the Prime Minister, the Minister of Finance, and the Governor for Belgium. His visit had provided a valuable follow-up to the Executive Board discussion for the Article IV consultation with Belgium and an opportunity to discuss economic developments in the country with politicians, trade unionists, bankers, and industrialists. In the afternoon, he had given a lecture on adjustment programs, which had been well received. He had also discussed arrangements for the Interim Committee meeting with Mr. De Clercq, who would be circulating a draft agenda to Executive Directors.

The Executive Directors took note of the report by the Chairman.

2. PANAMA - CONSULTATION UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the consultation under the 18-month stand-by arrangement for Panama in an amount of SDR 150 million (EBS/84/8, 1/11/84), and Panama's request for a waiver under the stand-by arrangement (EBS/84/8, Sup. 1, 2/6/84).

Mr. Arias made the following statement:

Although Panama's economic growth in 1983 was stagnant--the first year since 1976 that no positive growth was recorded--my Panamanian authorities have demonstrated their determination and ability to carry out successfully the 1983 economic program, despite the uncertain world framework. My authorities feel that the support provided by the Fund through the stand-by arrangement and by the World Bank through the recent approval of a Structural Adjustment Loan (SAL) has helped move the process of economic adjustment toward a sustainable growth path in the medium term.

Panama's economic and financial performance during 1983 was based on strengthening the fiscal position through a number of revenue and expenditure measures detailed in previous staff papers (EBS/83/102, 5/24/83; and EBS/83/192, 9/6/83). The annual rate of inflation has slowed to 2 percent. Public sector spending was substantially reduced through the curtailment of current expenditures, despite the wage adjustments to which the Government had committed itself in 1982. Government subsidies were gradually reduced; a luxury hotel with large operating losses was sold by public auction, an inefficient sugar mill was shut down permanently, and the support price for rice was reduced. Likewise, a number of investment projects were postponed and others eliminated. On the revenue side, a tax package was introduced, which increased taxes on imported petroleum and increased ship registration fees; quota restrictions were replaced by tariffs for a substantial number of import items. These measures were complemented by improvements in tax administration; technical assistance is being provided by the Fund in customs administration. Under the stand-by arrangement, the overall public sector deficit was projected to decline from $464 million in 1982, 11 percent of GDP, to $270 million in 1983, 6 percent of GDP. The staff in its recent visit to Panama estimated a public sector deficit of $260 million, which still represented 6 percent of GDP, owing to a lower GDP than had originally been assumed in the program. My authorities have recently provided the closing figures for 1983, which show an overall public sector deficit of only $247 million, equivalent to 5.7 percent of GDP. Public sector savings have substantially exceeded the targeted 2.7 percent of GDP in 1983.

The staff in its report had estimated a margin of $10 million under the limit on the overall deficit of the nonfinancial public sector for reasons described in EBS/84/8; the additional margin of $13 million was due in part to revenue resources that had not been foreseen. For instance, it was projected that $40 million would be received from the discounting of income tax promissory notes of the oil pipeline company with the international banking community. These notes actually yielded $47 million. Moreover, the Government renewed a contract with an overseas telecommunications company, contrary to earlier plans, for a fee of $5 million. Both payments were received at the end of December 1983.

The origin of the excess over the limits on foreign borrowing and the reasons why a waiver was requested are well explained in EBS/84/8, Supplement 1, in which the staff recommends approval of the Panamanian request.

In their effort to reorient economic activity, my authorities last year negotiated a structural adjustment program with the World Bank. It was supported by a loan of approximately $60 million, of which $40 million was disbursed late last year and the remainder will be disbursed by the end of the program, at the beginning of June 1984. As has been well explained in the staff report, the objectives of the Government under the Structural Adjustment Loan are to establish an appropriate economic structure based on adequate price policies and incentives to industry and agriculture and to improve the efficiency of the public sector. Studies to improve industrial and agricultural incentives are being undertaken with the assistance of the World Bank. Furthermore, Panama has complied with all the understandings reached with the World Bank under the program. My Panamanian authorities have already expressed to the Bank staff their intention to start new negotiations for another Structural Adjustment Loan after the current one expires.

In 1984 the Government intends to complement the structural measures taken in 1983 by continuing to improve the public finances by limiting the overall public sector deficit to $250 million, 5.5 percent of GDP, and public sector savings at 4 percent of GDP. This will be possible through a sound and cautious investment policy with capital expenditures maintained at 1983 levels, which is consistent with the investment program agreed upon with the World Bank. Importance will be given to projects of highest priority, such as those in the energy sector. It is expected that the hydroelectric project La Fortuna will be completed by October 1984, and it will generate savings on oil imports of approximately $65 million a year. Also, great attention will be given to the agricultural sector, particularly farming and irrigation projects.

During 1984, the total public sector deficit will be financed completely through multilateral and bilateral agencies, thus allowing the outstanding public debt contracted at commercial terms to be reduced from 52.2 percent of GDP in 1982 and 51.3 percent in 1983 to, at most, 46 percent in 1984.

My authorities believe that through the measures implemented and the resulting overperformance under the fiscal program, they have shown their commitment to carrying out the stabilization program. This, combined with the further efforts to be made in 1984, should enable them to reorient economic activity, and thus allow the achievement of the Government's medium-term objective of sustainable growth through a more rational use of available resources. Thus, I would like to request the support of the Executive Directors for the proposed waiver.

Extending his statement, Mr. Arias informed Executive Directors that the excess of $2.2 million on net commercial borrowing by the public sector had already been eliminated.

Mr. Erb indicated his agreement with the staff appraisal and his support for the revised proposed decision. The Panamanian authorities had implemented their adjustment program successfully in 1983, despite an external environment less favorable than envisaged. He welcomed the fact that in 1983 the overall deficit of the nonfinancial public sector had been no more than B 246.6 million, 8.7 percent below the original limit. That favorable outcome had been made possible by several unanticipated, one-time-only developments that had increased revenue, thereby reducing the budget deficit by about 22 percent. In the absence of those extraordinary developments and assuming that no compensating measures could have been taken, the overall public sector deficit would have been 7.2 percent of GDP in 1983, instead of the 5.7 percent of GDP actually attained, or the original target of 6 percent.

It was his intention not to detract from the authorities' achievements in 1983, but rather to highlight the challenge facing them in 1984, Mr. Erb indicated. Since the one-time extraordinary revenue items for 1983 were not likely to recur, public sector revenues would have to increase by 11 percent--nearly twice the rate of growth of nominal GDP in 1984--if the programmed level of expenditures and the deficit target were to be achieved. He would welcome further comment from the staff or Mr. Arias on how the authorities intended to achieve their fiscal deficit objective for 1984. He shared the staff's view that action should be taken to bolster public sector revenues, thus contributing to an increase in public sector savings in 1984 and beyond. Likewise, particular vigilance ought to be exercised over public sector spending in 1984, and he therefore encouraged restraint with respect to wages and salaries. Clearly, future wage increases in the public sector should be linked to productivity gains and should take into account developments in the productive sectors.

He agreed with the staff that the achievement of a more efficient resource allocation would depend on the dismantling of administrative trade restrictions and price controls, Mr. Erb went on. He welcomed the steps taken in that area in 1983, but continued progress was necessary if resources were to flow to Panama's more productive sectors.

The World Bank had granted a structural adjustment loan to Panama, Mr. Erb noted, and he welcomed Mr. Arias's statement that his authorities intended to start negotiations for another structural adjustment loan after the current one expired. The efforts of the Fund and the Bank in Panama were complementary, which should enhance the country's medium-term prospects.

The authorities' intention to increase reliance on bilateral and multilateral credit was appropriate, given Panama's debt profile, Mr. Erb considered. He agreed with the staff that the authorities should also try to negotiate commercial bank credit to cover the projected amortization of commercial debt in years subsequent to 1984.

Finally, regarding Panama's medium-term prospects, the country's debt service obligations would increase to more than 41 percent of exports of goods and services by 1986 and would remain in that range for some time, Mr. Erb remarked. The strategy of increasing reliance on bilateral and multilateral credit would have to be pursued over the medium term. The Fund's involvement should be essentially that of a catalyst for ensuring adequate financing. He expected that any future programs would, therefore, be precautionary in nature, as had been the case previously.

Mr. Delgadillo indicated his broad agreement with the staff appraisal and his support for the revised decision. Panama's financial performance under the program had been satisfactory in 1983, in particular with respect to the reduction in the overall fiscal deficit and the increase in public savings. The combination of expenditure and revenue measures adopted by the authorities had reduced the overall fiscal deficit substantially to the equivalent of 5.7 percent of GDP from 11 percent of GDP in 1982. In addition, the greater than targeted increase in public savings had made possible a larger than projected level of capital expenditure, helping to avoid a negative rate of economic growth.

Most of the measures adopted to strengthen the public finances had led to a better resource allocation in the economy, Mr. Delgadillo observed. The reduction in subsidies, the replacement of import quotas with tariffs, and the adoption of a sound pricing policy for public enterprises had been particularly important in that regard. Owing to the implementation of those adjustment measures, which reflected the commitment of the authorities, most of the performance criteria included under the program had been met with substantial margins, in particular, the targets for the nonfinancial public sector deficit and for net credit from the National Bank to the nonfinancial public sector.

He supported Panama's request for a waiver of the limits on net external borrowing and of the sublimit on public sector net commercial borrowing, in view of the substantial margin achieved under the fiscal program for 1983, the sizable increase in the National Bank's liquid reserves, and the temporary nature of the breach of those limits, Mr. Delgadillo stated. Finally, he welcomed Mr. Arias's assurance that Panama had complied with all the understandings reached with the World Bank under the structural adjustment program; the authorities were committed to strengthening the economic base through adequate pricing policies and incentives to industry and agriculture, while improving the efficiency of the public sector.

Mr. Joyce recalled that at EBM/83/92 he had noted that previous adjustment efforts by the Panamanian authorities had run aground and that the economy had deteriorated in many areas. His chair had stressed that adjustment measures were urgently needed and should be pursued vigorously. It was clear from Mr. Arias's statement and the staff appraisal that the authorities had shown resolve and determination during 1983 in redressing the deterioration in Panama's economic situation. Progress under the stand-by arrangement had been generally satisfactory, even though economic developments had been less favorable than expected. He particularly welcomed Panama's success in reducing the size of the overall public deficit, despite adverse circumstances in Panama's export market. Improvement in the trade balance had been achieved only through vigorous belt tightening in the economy and the consequent reduction in the demand for imports.

He congratulated the authorities on eliminating some export controls and quantitative import restrictions; on reducing price rigidities affecting beef, milk, and other domestic foodstuffs; and on abolishing price controls on a number of foods, Mr. Joyce went on. However, there had been some slippages. Delays in implementing administrative reforms had undermined to some extent the revenue efforts, causing the erosion of the margin in the overall fiscal deficit that had existed in June and September 1983. Additionally, performance criteria for end-December on net foreign and commercial borrowing by the public sector had not been observed, although those breaches were related to delays in disbursements from the World Bank and donors.

He could support the proposed economic program for 1984, Mr. Joyce indicated. The staff report rightly focused on the need for continued improvement in the government accounts. Owing to the narrow range of policy tools available to the authorities, it was essential that fiscal policy be kept on track. The targeted reduction in the overall fiscal deficit to 5.5 percent of GDP in 1984 appeared to be consistent with the objective of achieving a sustainable external position by the end of the stand-by arrangement, given a reasonable level of capital inflows. On the revenue side, he welcomed the improvement in the collection of customs and related sales taxes; he hoped that those measures--initiated in December 1983--would bear fruit in 1984.

The adjustments in rates and prices of the state enterprises were expected to increase their operating surplus substantially in 1984, Mr. Joyce went on. Nevertheless, the overall deficit of those enterprises was still expected to exceed $60 million in the current year. Could Mr. Arias or the staff indicate whether the authorities were considering any additional measures to reduce the deficits further in the medium term and, more specifically, in 1985?

On the expenditure side, Mr. Joyce continued, he welcomed the involvement of the World Bank in Panama's public investment program. Slippages in that area had posed problems for the authorities under the previous stand-by arrangement. The authorities should be careful to avoid any new wage commitments in the public sector.

As for external policies, the authorities' intention to complete the conversion of import quotas to tariffs during 1984 was commendable, Mr. Joyce stated. Those measures would contribute to an improved allocation of resources in the economy. It was appropriate for the authorities to attempt to slow down the rate of growth of external debt and improve its maturity structure. Nevertheless, Table 19 of EBS/84/8 suggested that debt service obligations would increase significantly over the next several years; and it would, therefore, be important for the authorities to maintain a cautious approach to external borrowing even after the end of the program period. The flexibility in the Fund's treatment of performance criteria with respect to new external borrowing by the public sector would permit an improvement in the maturity structure of Panama's external debt, should the expected level of disbursements from bilateral and multilateral sources be exceeded. In conclusion, he fully supported the proposed decision.

Mr. Feito indicated his support for the proposed decision. Panama's performance under the present stand-by arrangement had been satisfactory. Substantial progress had been made in correcting the fiscal and other imbalances of the economy. All performance criteria, except those related to net external borrowing, had been met. The requested waiver was clearly justified; the excess on external borrowing had been due to transitory factors, and had been more than offset by lower than expected flows of net domestic borrowing as a result of overperformance in the fiscal area.

Developments thus far and the structural changes contemplated under the stand-by arrangement were most encouraging, in spite of the stagnation of economic activity, Mr. Feito considered. The public sector deficit had been halved, and public sector savings had exceeded the program target by more than 1 percentage point. Equally important, the agreement with commercial banks to reschedule amortizations due in 1983 and 1984 had facilitated the stabilization effort, while improving the maturity structure of the external debt.

The successful implementation of fiscal and external debt management policies had been accompanied by the adoption of far-reaching measures associated with the World Bank structural adjustment loan, Mr. Feito noted. The rationalization of the prices of public goods and services, the gradual elimination of price controls, the restructuring of industrial and agricultural incentives, and the accelerated replacement of import quotas with tariffs, were important steps toward improving the efficient allocation of resources in the economy. He commended the authorities for their determination in implementing those structural measures and for complying with all the understandings reached with the World Bank in that respect.

The 1984 adjustment program was aimed at maintaining macroeconomic discipline and achieving further progress in structural adjustment, Mr. Feito observed. The fiscal measures contemplated for 1984 would rationalize fiscal instruments and reduce the budget deficit, thereby improving the finances of the public sector. External debt management, aimed at limiting borrowing from bilateral and multilateral sources, would further improve the debt service profile in the medium term. He was encouraged to note from Mr. Arias's statement the importance attached by the authorities to cooperation with the World Bank and their intention to start negotiations on a further structural loan. In previous cases, successful adjustment had been achieved in countries adopting programs supported by both the World Bank and the Fund. In sum, the external adjustment program had been implemented satisfactorily thus far. By maintaining nominal demand restraint and strengthening the supply side of the economy, the program for 1984 would help to restore conditions for sustained and stable economic growth.

Mr. Moerke stated that he shared the views expressed by other Executive Directors. Encouraging results had been achieved in important areas of the economy, and the program for 1984 appeared to be broadly appropriate. Nevertheless, given the relatively high external debt and debt service burden, a faster adjustment in the public sector would have been desirable. He realized that the public sector deficit in 1983 had been reduced dramatically, and that some decrease in the speed of that reduction might therefore be understandable. Finally, he could support the proposed decision.

Mr. El-Khouri remarked that the implementation of the 1983 adjustment program had been generally satisfactory. The reduction in the fiscal deficit, the centerpiece of Panama's adjustment effort, had been greater than programmed. The authorities had also implemented a number of structural adjustment measures in taxation, domestic pricing, and the import system. Furthermore, the deviation from the quantitative performance criteria toward the end of 1983 had been temporary and had not represented a relaxation of the adjustment effort.

With respect to the 1984 program, Mr. El-Khouri went on, the programmed reduction in the fiscal deficit by 0.5 percentage points of GDP might appear to be small; however, considering the reduction in 1983, the fiscal adjustment effort over the entire period of the stand-by arrangement was impressive. The staff had not addressed sufficiently the issue whether further fiscal adjustment would be needed beyond 1984 to achieve a sustainable external payments position in the medium term. The projections of external debt service had been based on the assumption that future budget deficits would be moderate, but the staff had not explained what it meant by moderate. It would be useful if the staff could comment further on the issue of fiscal adjustment and on the outlook for the medium term.

Finally, he welcomed the authorities' intention to continue with the structural reforms begun in 1983, Mr. El-Khouri stated. The conversion of most import quotas into tariffs, the rationalization of pricing policies, and the strengthening of incentives for agricultural and industrial production, were steps that should lead to a more efficient resource allocation and a stronger productive base for the economy. In conclusion, he commended the authorities for their adjustment effort, and he could support the proposed revised decision.

Mr. Morrell indicated his support for the proposed decision, including the waiver on the limit relating to net external borrowing and net commercial borrowing. He complimented the authorities for adhering to the basic objectives of the program. Commendable achievements had been made in the fiscal area with respect to the rate of inflation and the removal of administrative controls. The reduction in the fiscal deficit in 1983 had been satisfactory, but he wondered whether the adjustment proposed for the remaining 12 months of the program was sufficient. There was a need for more measures to be taken on the revenue side in 1984. The authorities' decisions to eliminate a mandatory contribution by workers to the Social Security Agency and to exempt a banana-exporting company from an export tax did not seem to be fully consistent with the objective of restoring external viability. He wondered why the staff had not referred to any effort by the authorities to raise finance internally from the private sector. He presumed that the Government was unable to do so because of the unusual currency arrangements in Panama. One source of financing used by the authorities, the discounting of income tax promissory notes, was a form of internal borrowing; was that just short-term borrowing, or would future revenues be brought forward, thereby causing some adverse fiscal effects later in 1984? In any event, he supported the proposed decision.

The staff representative from the Western Hemisphere Department, commenting on the adequacy of the revenue measures in 1984, said that the revenue projections had been made on a conservative basis and that the estimates of the two main sources of additional revenue--an increase in import duties and a rise in the operating surplus of state enterprises--were reasonable. Import duties in 1983 had increased by 4 percent, even though imports had fallen by 20 percent, reflecting both the change from quotas to tariffs and the increase in tariffs, the full effect of which would be realized in 1984. In addition, a moderate increase in imports was expected. The other major revenue source was the substantial increase in the operating surplus of the electricity company; the completion of the La Fortuna hydroelectric plant, which was to begin operating in 1984, would result in savings in fuel costs.

On the expenditure side, there were control measures that would enable the authorities to keep expenditures to budgeted levels, the staff representative went on. The continuous high overall deficit of the state enterprises related primarily to the investment project of the electricity company; the completion of that project alone should reduce the investment program of the public sector by the equivalent of about 1.5 percent of GDP. As a result, the overall deficit of the state enterprises would be substantially less in 1985. The public investment program was projected to be reduced from about 9.5 percent of GDP in 1984 to 7 percent of GDP in the mid-1980s under Panama's structural adjustment program with the World Bank. Given the expected level of public sector savings in 1984, the reduction in capital expenditure should lead to an average overall deficit of about 4 percent of GDP for 1985-87. The staff considered such a deficit to be financeable.

Under the program, local bond issues were regarded as part of the external commercial borrowing, the staff representative from the Western Hemisphere Department explained. Domestic bond issues had not been a major source of financing in the past and were not expected to be a major source in the future. The discounting of income tax promissory notes did, in effect, bring forward revenues that would have matured at a later date. It did not create future adverse effects, however, because the income tax obligations of the oil pipeline company would continue to accrue quarterly for a number of years.

The Executive Board then took the following decision:

1. Panama has consulted with the Fund in accordance with paragraph 4(c) of the stand-by arrangement for Panama (EBS/83/102, 5/24/83) and paragraph 21 of the letter of April 29, 1983 attached thereto in order to reach understandings with the Fund regarding the policies and measures that Panama will pursue during the period from January 1, 1984 to December 31, 1984.

2. The letter dated December 31, 1983 from the Minister of Planning and Economic Policy, the Minister of Finance and Treasury, and the General Manager of the National Bank shall be attached to

the stand-by arrangement for Panama (EBS/83/102, 5/24/83), and the letter of April 29, 1983 shall be read as supplemented and modified by the letter dated December 31, 1983.

3. Accordingly, the limits and ceilings referred to in paragraphs 15, 16, and 17 of the letter of April 29, 1983 on the cumulative deficit of the nonfinancial public sector, the net credit by the National Bank to the nonfinancial public sector, and the cumulative net external and net commercial borrowing for the public sector, shall be those referred to in paragraphs 3, 7, and 8, respectively, of the letter of December 31, 1983.

4. The Fund finds that no additional understandings are necessary concerning the nonobservance of the performance criteria regarding the cumulative net external and net commercial borrowing of the public sector for the period January 1, 1983 to December 31, 1983 and that Panama may make purchases under the stand-by arrangement.

Decision No. 7621-(84/20), adopted
February 8, 1984

## 3. DENMARK - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with Denmark (SM/84/3, 1/4/84; and Sup. 1, 2/3/84). They also had before them a report on recent economic developments in Denmark (SM/84/27, 1/25/84).

Mr. Tvedt made the following statement:

When the Executive Board discussed the previous consultation with Denmark in January 1983, the new Government's economic program for 1983 had, to a large extent, been put in place. However, in the important field of incomes policy, it was still an open question whether it would prove possible to reach agreements between the parties in the labor market within guidelines of moderation established by the Government in autumn 1982. As can be seen from the staff report, it did prove possible to conclude two-year contracts that respected the established guidelines without any labor conflicts. Actually, 1983 was a year with very few strikes within Danish industry. Within the framework of the legislation adopted in autumn 1982, a salient feature of the agreements was a suspension of the automatic escalator clauses for wages and salaries for two years until spring 1985. The latest available statistics on industrial wages indicate that the annual rate of increase in hourly wages in manufacturing industry in the course of 1983 has come down to about 4.5 percent compared with about 9.7 percent one year earlier, meaning that wage drift has been of limited importance. Alongside this moderation in wages, the rate of increase in consumer prices has also been reduced perceptibly.

At this time, no detailed program has been laid down regarding incomes policy beyond spring 1985, but the strategy of the Government is clear: both for domestic reasons and in the light of the deceleration in cost and price increases in other European countries, the Danish authorities will endeavor to reduce the future annual rate of increase in wages and salaries to below the rate of 4-5 percent reached in 1983. In order to achieve such a result, it would clearly be desirable to avoid a reactivation of the automatic escalator clauses in the Danish labor market. At the same time, the Government would like to see a solution in which the evolution in wages and salaries is determined by agreements entered into voluntarily between employers and trade unions.

The adjustment in 1983 in the Danish economy took place more rapidly than expected a year ago. Clearly, the decline in energy prices in dollar terms and the reduction of international interest rates have helped to improve the economy, but the distinct dampening of wages and salaries has also contributed to a substantial improvement in the balance of payments. According to the latest Danish estimates, the surplus on the balance of goods and services increased from just below DKr 4 billion in 1982 to DKr 12.75 billion in 1983. On account of high interest payments, the current account deficit is estimated to have been DKr 10.7 billion in 1983, a decline of about DKr 8 billion from 1982.

Against a background of the decline in international interest rates, the deceleration in domestic price increases and the increased confidence in the stability of the exchange rate of the krone within the European Monetary System (EMS) led to a drastic decline during 1983 in both short-term and long-term interest rates in Denmark. However, real rates of interest are still high by international standards.

As a consequence of the tightening of fiscal policy adopted in autumn 1982, domestic demand grew only slowly in the first half of 1983. However, the marked deceleration in domestic price increases and the decline in interest rates led to an improvement in the economic climate in the course of 1983. On a seasonally adjusted basis, the rate of unemployment, after sharp increases in the preceding years, has remained more or less stable since spring 1983. Another indication of an improvement in the economic situation has been an unexpected pickup in the revenue from indirect taxes. This development explains to a considerable extent why the central government deficit, according to preliminary accounts, is DKr 4.6 billion lower than the original estimates for 1983 available at the time of the Fund discussions in November.

Revised estimates, published in January 1984, confirm the view presented in the staff report that the authorities' October estimates for developments in demand and production tended to be too possimistic. It is now evident that the second half of 1983 saw a fairly sharp increase in the volume of private consumption. Similar developments are evident in other European countries. In Denmark, there is thus far no evidence of a corresponding increase in real disposable income. At this stage, the impression is that the improvement in the economic climate has led to a reduction in the savings ratio of private households. It is impossible to predict whether this is a temporary phenomenon or whether it will also be felt in 1984.

At the same time, the sharp reduction in long-term interest rates has been an important factor behind the recovery in the construction of single-family houses. Residential construction was depressed in 1981 and 1982, so that, even with a fairly sharp increase in the construction of new dwelling units in 1984, there should be no risk of demand pressure in this sector.

Although it is encouraging that the rate of inflation has been reduced and that the increase in the rate of unemployment has been stabilized, it gives reason for concern that the sharper than expected upturn in domestic demand in the second half of 1983 seems to have brought the reduction in the current account deficit to a halt.

Revised official Danish projections indicate an increase in the Danish GNP in volume terms of 2.5 percent from 1983 to 1984. At the time of the Fund discussions in November, the growth rate for 1984 was estimated to be of the order to 1.5 percent. Such an increase would have meant that production in Denmark would have increased at a slightly slower pace than projected for the European OECD countries; a rate of increase of 2.5 percent, on the other hand, may bring the growth rate in Denmark above the expected average for its European trading partners. Since the expectation of higher growth is based on an estimated increase in domestic demand, it is likely to have a negative impact on the current account position. At the same time, the estimates for agricultural export prices are less favorable than three months ago. Taking these factors into account, the authorities expect that the current account deficit in 1984 will amount to DKr 12 billion, or about DKr 1.3 billion higher than the preliminary estimate for 1983.

After the parliamentary elections early in January, the Danish Government has reconfirmed that its objective is to reach equilibrium in the current account in three to four years' time. Against this background, the expected deterioration in the current account position in 1984 gives cause for serious concern. Clearly, the change in the 1984 estimates indicates the need for increased caution both in fiscal policy and in monetary policy.

Disagreements on the central government budget for 1984 were a main reason for the calling of parliamentary elections in January. On account of these disagreements, only temporary budget provisions have so far been adopted for 1984. As part of the work of the new Parliament, which was resumed earlier this week, the adoption of a final 1984 budget will be a matter of high political priority. The "automatic" improvements in the government accounts in the second half of 1983 are also expected to influence fiscal developments in 1984. In the budget proposal introduced in Parliament after the election, it is estimated that the deficit on the current, investment, and lending accounts will be slightly lower in 1984 than in 1983, despite the fact that interest payments are expected to go up by alomost DKr 10 billion.

The Government shares the staff's view on the negative impact of further increases in an already high level of taxation in Denmark. However, as the Government--even after the election--does not command a clear-cut majority in Parliament, a further reduction of the 1984 budget through cuts in expenditure may prove difficult. In introducing the revised 1984 budget the Minister of Finance indicated that it would be the Government's objective to reduce the deficit on the current, investment, and lending accounts in 1985 to about DKr 50 billion.

As pointed out by the staff, the improved economic conditions in 1983 in some ways made the management of Danish monetary affairs more difficult. The sharp improvements in the foreign balance of the private sector and the substantial bond purchases by Danish banks led to a sharp increase in the money supply. Since it was considered inadvisable to hamper an upswing in investment activity with measures that would lead to increases in interest rates, and since the Danish foreign exchange situation after the exchange rate adjustment within the EMS in March 1983 was calm, the monetary authorities were reluctant to take drastic action in 1983 to limit the expansion of the money supply. However, when bank lending in December showed an increase well above the average rate of increase agreed between the National Bank and commercial banks, the National Bank in January warned the banks that the rate of increase of bank lending should be brought down in the course of the next few months. Otherwise, the National Bank will find it necessary to restrict the access of the banks to take up short-term loans from the central bank. It is expected that the rate of increase in the money supply will be much lower in 1984 than in 1983. The Danish authorities in 1984 will endeavor to bring about a situation in which a relatively higher proportion of the government bonds sold on tap are placed with purchasers other than the banks than was the case in 1983.

As indicated during our discussion last year, the Danish authorities hold the view that the achievement of a moderate increase in wage costs is the preferable way to improve the competitive position of Danish industry, as opposed to an active use of the exchange rate mechanism. This view was reiterated in the government statement delivered in Parliament in January after the recent election.

In relation to the EMS, the Danish authorities are aiming at maintaining a more or less stable relationship between the krone and the European Currency Unit (ECU). Thus, during the realignment within the EMS last March, the authorities chose to place the krone in such a way that it was devalued by 3 percent against the deutsche mark and appreciated by 5 percent against the French franc and the lira. In line with their EMS partners, the Danish authorities note with satisfaction that conditions within the EMS have been calm since the March realignment. At the same time, there are signs of a gradual convergence among EMS members. If this trend continues, the Danish authorities would hope that the intervals between the realignments within the EMS will become much longer than they were between September 1981 and March 1983.

On account of Denmark's large net liabilities in U.S. dollars and its position as a net importer of energy, the further increase in the exchange rate of the dollar in 1983 has on balance been a factor that has made the reduction of the current account deficit and the reduction of the rate of inflation more difficult.

The Danish authorities agree with the staff that economic developments in 1983 had many encouraging features. Although the pickup in private domestic demand, which has made itself felt since last summer, is in itself welcome, the Danish authorities are aware of the risks on the balance of payments side, which will result if domestic demand in Denmark continues to grow faster than in the economies of the country's main trading partners.

The Danish authorities are maintaining their objective of eliminating the deficit on the current account in three to four years, and it will also aim at continuing to reduce the deficit in the Central Government's current, investment, and lending accounts in both 1984 and 1985. If developments in the course of spring 1984 substantiate the revised forecast for the 1984 balance of payments, the Government is prepared to take new initiatives to improve the external balance.

The increase in the money supply is expected to be much lower in 1984 than in 1983, and the National Bank has warned the banks that a continued rapid increase in their lending activity will not be accepted.

A main objective of economic policy over the next 12-15 months will be to make a further reduction in the rate of increase in wage costs and prices. Recent experience has shown the advantages of basing an incomes policy on voluntary agreements, and in the Government's view it will clearly be desirable to avoid introducing a statutory incomes policy in 1985. However, it remains the view of the Government that it would be undesirable to return to the use of automatic cost of living adjustments of wages and salaries in 1985.

Mr. Schneider commented that it was evident from the staff papers that there were a number of similarities between the economic disequilibria in Denmark and those in Belgium, with which country the Executive Board had concluded a consultation at EBM/84/8 (1/18/84). The adjustment policies in those countries also seemed to follow broadly the same pattern: the authorities were gradually reallocating resources from households toward enterprises and the balance of payments, and they were also reducing the fiscal deficit.

The transfer of income from households to enterprises had initially been based on a series of exchange rate adjustments supported by wage moderation, Mr. Schneider observed. More recently, increased emphasis had been placed on an active incomes policy, while exchange rate adjustments had been discontinued. The latest approach seemed to have been more effective in Denmark, a small, open economy, because it permitted a substantial lowering of inflation. Wage moderation, achieved primarily through the suspension of the wage indexation mechanism until spring 1985, had improved external competitiveness. However, it was vital for the confidence of private enterprises that the expectation of further wage moderation after 1985 should be maintained. Ideally, wage settlements should be left to negotiations between management and labor. But even if the indexation mechanism was reintroduced, it should be made more flexible by correcting for movements in the terms of trade and for changes in indirect taxes.

Although the improvement in competitiveness had been well documented in the staff papers, there was less evidence of the profitability of enterprises, particularly in the manufacturing sector, Mr. Schneider observed. The staff could have usefully included some analysis of the financial situation of those enterprises by sector. Could the staff elaborate further on the issue? An improvement in the profitability of the manufacturing sector was essential for further progress; it was a precondition for a recovery of investment and a reduction in unemployment, while maintaining a stable external sector. The manufacturing sector contributed to only about 18 percent of value added in GDP. The major structural weakness of the Danish economy was the relatively small size of the exposed sector, which was also experiencing a low level of profitability. Since investment outside the gas and oil sector had declined considerably in the past years, some further action might be required to improve profitability in the exposed sector. The indicators of cost competitiveness were perhaps too optimistic; productivity increases had been artificially boosted by the shedding of labor. Some other indicators, such as the share of profits in value added, might provide additional useful information.

On the budget side, the Government was pursuing an appropriate policy of gradually reducing the deficit through emphasis on expenditure restraint, Mr. Schneider remarked. The budget situation was still uncertain, however, owing to the recent parliamentary elections. As experience in 1982 had shown, it was essential to keep fiscal stimuli in check in order to avoid a deterioration in the external balance as a result of domestic demand. A smaller budget deficit would increase the scope for public savings, which were necessary to finance a higher level of investment without applying pressure on the external current account. Indeed, unless further improvement was registered in the current account as a result of improved competitiveness, any change in domestic demand would have to be achieved by altering its initial components.

There was scope for improvement in the fiscal balance, particularly by restricting social transfers, which continued to increase in real terms, Mr. Schneider continued. There appeared to be little political agreement on that issue; consequently, taxes had been increased, thus adding to labor costs. If revenue-raising measures could not be avoided, more attention should be directed toward raising indirect taxes, which represented only 35 percent of total fiscal revenue at present. Higher indirect taxes would constrain consumption and would stimulate savings. The reduction in the public sector deficit should be gradually implemented in order to avoid an excessive deflation of domestic demand that could further weaken the fiscal balances.

Monetary policy had been directed toward maintaining external balance, Mr. Schneider observed. After the March 1983 exchange rate alignment within the European Monetary System, interest rates had been reduced in an effort to stimulate investment. Although that policy had been appropriate, interest rates had fallen more for bonds than for bank deposits, and public preference had shifted toward the latter. There might be some room for changing the taxation of interest income, which seemed to favor short-term investments. In view of the need to constrain domestic demand and reduce the liquidity overhang, the attractiveness of longer-term financial instruments should be increased. The rising proportion of the budget financed by the banks had become somewhat worrying.

He fully shared the authorities' view on exchange rate policy, Mr. Schneider went on. It was best under present conditions to safeguard external competitiveness through wage restraint and to follow a firm exchange rate policy. The liberalization of capital controls and the general adherence to the principles of free trade were also commendable. He complimented the authorities for maintaining the level of official development assistance above the UN target, despite the difficult economic situation.

In sum, the authorities were making appropriate adjustment efforts to combat the underlying imbalances, Mr. Schneider concluded. However, more emphasis on certain aspects of the adjustment process might accelerate the restoration of sound economic growth.

Mr. de Vries considered that although improvements in the economy had been made by the Danish authorities, further progress would be necessary. In Denmark, as in many countries, economic adjustment had proved to be more difficult than originally envisaged.

The slow growth of the manufacturing sector during the 1960s and 1970s had been a major structural problem, Mr. de Vries considered. It was difficult for the authorities to pursue a demand management policy that would maintain both employment and a sustainable balance of payments position. Could the staff elaborate on the structural maladjustments of the economy and on how the authorities could reallocate resources to the exposed sector within the framework of price stability and a fixed exchange rate?

Between 1979 and 1983, unemployment had nearly doubled, although the Danish population had remained stable and employment had remained level, Mr. de Vries observed. He assumed that those facts could be explained by the entry of women into the labor force. Had women been taking the place of men in the labor force, thus increasing household income? Although women earned lower salaries, men could receive unemployment insurance. Such a situation was not consistent with the Government's aim of reducing the budget deficit. Could the staff comment further on that issue?

The rise in government expenditure had been halted, Mr. de Vries noted, and the budget deficit remained stable. He was concerned, however, about the distinction between the budget deficit excluding interest rate costs and the deficit including interest rate costs. Interest would have to be paid, and it should therefore be included in the deficit.

Liquidity had been increased to finance the government deficit, Mr. de Vries remarked. Monetary expansion had been about 24 percent during the 12 months ended September 1983, about three times the nominal increase in cost. The situation was even more serious than the staff had indicated: there had been much monetization of long-term debt, and there was a need to limit the financing of the deficit by the banks. An increase in long-term interest rates was therefore called for.

Further improvement of the budget situation through a reduction of expenditures was urgent, Mr. de Vries considered. The authorities had shifted emphasis toward revenue-raising measures, but he was concerned that that approach would not solve the problem. Closer analysis of social security expenditures was necessary, in particular in relation to the possible replacement of men in the labor force by women. Without some reduction in social transfers, the government deficit was unlikely to be reduced.

The Danish authorities issued government bonds at a relatively low nominal interest rate, effectively deferring the interest payments, Mr. de Vries noted. Although the low interest rate helped to alleviate the heavy interest rate burden of the Government at present, it might make the problem worse later on. There was therefore an additional reason for hoping that the authorities would improve the budget situation, especially by reducing expenditures.

He welcomed the change in wage policy, Mr. de Vries stated. The deterioration in Denmark's competitive position had been halted. However, he shared the staff's view that further action was needed in that field to increase the competitiveness of the manufacturing sector, which had declined in the 1960s and 1970s.

In sum, although important steps had been taken by the Government, additional difficult measures would be necessary, Mr. de Vries remarked. He agreed with the authorities' fixed exchange rate policy within the European Monetary System, but domestic measures would have to be taken in order to make that policy successful.

Mr. Templeman remarked that the authorities had made some progress in reducing the rate of increase in labor costs and price inflation and in improving the competitiveness of the economy. With the help of increased domestic energy production and energy conservation, the current account deficit had been reduced significantly, and the net outflow of private capital had been reversed between 1981 and 1982. Initial steps had been taken in recent years to arrest the steady increase in the public sector deficit, both in absolute terms and as a share of GDP. However, the steady rise in unemployment, at least until spring 1983, raised questions about the rate of growth of productive investment in the long term.

The two-year suspension of wage indexation until spring 1985, with a 4 percent limit on public sector pay increases and a similar guideline for private sector settlements, had been an initial success, Mr. Templeman considered. Continued wage restraint, coupled with reasonably good productivity growth, would keep the rise in unit labor costs low enough to preserve the recent improvement in Denmark's competitive position. The authorities' strategy after spring 1985 was to reduce the rate of increase in wages and salaries below the 4-5 percent rate achieved in 1983. Although a detailed program to achieve that target had not yet been decided, wage policy would be crucial to Denmark's anti-inflationary efforts. The Danish case--as well as the cases of Belgium and Italy, recently examined by the Board--provided another example of efforts being made in industrial countries either to eliminate or to reduce the degree of automatic wage indexation. It would be interesting for the staff to prepare a report for the Executive Board on experience in that important but politically sensitive area. Two aspects of indexation schemes would be of particular interest: first, their effects in perpetuating overall inflation, and, second, their differential effects on relative wages and prices.

Denmark's situation exemplified the importance of reducing the public sector deficit in order to strengthen savings and investment, Mr. Templeman went on. The pattern was familar: high and rapid growth in public expenditure as a share of GDP, with transfer payments accounting for the largest increase; a level of taxation that might have reached an upper limit from a political viewpoint; and rising interest payments that rapidly compounded the difficulties of reducing expenditure growth.

It was not clear how the new Government intended to address the large deficit projected for 1984, Mr. Templeman continued. Most of the deterioration in the public sector could be accounted for by the central government deficit. Of total estimated 1983 expenditures, about 41 percent had been accounted for by transfers to local governments, 11 percent by reimbursement to social security funds, and 14 percent by interest payments. The impact of some of those transfer payments was difficult to judge, however, because of the complicated financial relationships between the Central Government and local governments. It appeared that, to a large extent, the local governments served as a passthrough for transfer payments to the household sector from the Central Government. Could the staff indicate briefly whether transfers by the Central Government to local governments would need to be lowered as part of a further reduction in the public sector deficit? If so, what were the authorities' plans for bringing that reduction about? He would also welcome an elaboration of the role of central government transfer payments for social insurance purposes as a component of the public sector deficit. What further action might be taken to reduce the public sector deficit?

Negative public sector savings had contributed to a weakening in the overall domestic savings level and a fall in gross domestic savings from more than 24 percent of GDP in 1973 to about 13 percent of GDP in 1982, which was a cause for concern with respect to Denmark's long-term growth potential and its ability to create new jobs and reduce unemployment, Mr. Templeman considered. That concern was compounded by Mr. Tvedt's suggestion that the household savings ratio might have fallen in 1983. Furthermore, the ratio of gross domestic investment to GDP had declined from about 21 percent in 1979 to about 16 percent in 1981 and 1982. What had been the ratios of savings and investment to GDP in 1983? Business investment had shown a positive real growth in 1982 and 1983, although housing and general government investment had declined sharply. The relatively better performance of productive private investment suggested a somewhat better growth prospect for Denmark than did the overall investment figures.

Monetary growth--both domestic credit expansion and the growth of broad money--had been accelerating over the past few years, at least through November 1983, when the growth of broad money had been almost

24 percent above that for the previous 12 months, and about double that for 1982, Mr. Templeman observed. Although the increase in liquidity in 1983 might have been due in part to a shift in liquidity preference to more normal relationships, that development deserved close monitoring.

The faster than expected economic recovery in Denmark in 1983--at a time when the budget deficit remained a serious problem and monetary expansion had accelerated--threatened to inflate the current account deficit of the balance of payments, Mr. Templeman continued. The Government's objective of eliminating the deficit on current account in about four years, a target that did not seem to be overambitious, could be jeopardized; increased caution on monetary and fiscal policy was therefore necessary.

Denmark's growing public debt service problem had consequences for the balance of payments and the budget, Mr. Templeman noted. The foreign debt service ratio had nearly doubled from 13 percent of exports of goods and services in 1980 to over 23 percent of exports in 1983, a high ratio for an industrial country.

Denmark had made a good start in re-establishing its competitive position, most notably through wage restraint, Mr. Templeman stated. Wage restraint, as well as monetary restraint, would have to continue, particularly in view of the authorities' aim to maintain a high degree of exchange rate stability. More important, a continued large public sector deficit posed a threat to the restoration of a more satisfactory savings and investment position. Persistent deficits on current account in a high-income industrial country raised questions about the long-term appropriateness of Denmark's present relationship between consumption and investment. Such problems were shared by many industrial and developing countries.

Mr. Blandin remarked that the authorities' results, both in the external and internal fields, were impressive. Their objectives on the external front were to be achieved through a combination of measures intended to increase the competitiveness of the export sector. The balance of payments situation had improved substantially, and the current account deficit had declined by about DKr 8 billion compared with 1982.

On the fiscal side, the action taken in 1982 had been substantial when measured in terms of public sector revenues--which had increased by 14 percent in 1983 compared with 11.8 percent in 1982--or in terms of the reduction in expenditure growth of 12.4 percent in 1983 compared with 16.4 percent in 1982, Mr. Blandin observed. Inflation, at almost 12 percent in 1981, had slowed to 10 percent in 1982, and to about 7 percent in 1983.

Although those successes were impressive, there was some reason for concern in 1984, Mr. Blandin considered. The upturn in domestic demand and the less favorable prices for agricultural exports were likely to have a negative impact on the current account deficit, which was expected to widen further in 1984. Were the external adjustment measures sufficient? As the authorities were aiming to reach external equilibrium within four years, external adjustment deserved higher priority, particularly given the burden of external debt, which represented one third of GDP, and the risk of a deterioration in the current account.

The share of public expenditure, at about 54 percent of GDP, was one of the highest in the OECD countries and was a cause for concern, Mr. Blandin remarked. Continuing large budget deficits would lead to the crowding out of the private sector. The Danish authorities should decide whether to increase revenues or to reduce public expenditures, the course that the staff seemed to prefer. In view of the growth of domestic demand in the second half of 1983, measures on the revenue side might also be required in order to restrain consumption and minimize the adverse effects of incentives to savings and investment. A tight monetary policy, including the close monitoring of monetary expansion, particularly of broad money, would be appropriate.

Specific structural reform measures should be implemented to strengthen the economy, Mr. Blandin said. He was concerned that the adjustment effort had been borne by domestic investment, which had declined from 26 percent of GDP in 1978 to 16.5 percent in 1982. Business investment outside the energy sector had declined by a greater amount. The damaging effect of large deficits and high interest rates on housing and business investment was evident. It was fair to recognize, however, that Denmark was not the only country in such a situation. The Danish authorities should take advantage of the improved economic conditions to adopt a stronger industrial policy directed toward growth sectors and to seek a reduction in the real interest rate differential.

On the positive aspects of the Danish economy, the authorities' intention to rely on market mechanisms, rather than try to improve competitiveness by frequent exchange rate adjustments, should be commended, Mr. Blandin considered. The increase in oil and gas production, combined with efforts to reduce energy consumption, had contributed to reducing the energy bill and, consequently, to improving the external current account. The authorities' wages and incomes policy was appropriate, as it had helped to restore Denmark's competitiveness. He agreed with Mr. de Vries and the staff that the authorities should continue their efforts in that field and that the indexation system should be abolished after 1985 and replaced with free negotiations. Finally, it was commendable that, despite its present economic difficulties, Denmark's aid to less developed countries exceeded the UN target.

Mr. Grosche commended the Danish authorities for the progress achieved thus far. Denmark provided evidence that a clear shift in macroeconomic policies induced positive effects not only in the long term, but in the short term as well. Prices and wages had moderated considerably, increasing the profitability and competitiveness of the Danish economy. Investment had risen, and the current account deficit would be reduced significantly.

Nevertheless, there were problems to confront, Mr. Grosche remarked. The budget deficit in 1984 would be only slightly lower than in 1983, and the high level of external debt called for a further substantial improvement in the external current account. Fiscal policy should remain tight; the high share of public sector spending in relation to GDP underscored the need for measures on the expenditure side.

Monetary policy should aim at reducing the growth of monetary aggregates, which had exceeded the rate warranted by shifts in portfolio and liquidity preferences, Mr. Grosche considered. Monetary expansion had stimulated private domestic consumption and had been the main factor behind the recent growth in real output. Repercussions of the present stance of monetary policy on the exchange rate and the price level had not yet been felt, but the danger was imminent. The National Bank had warned commercial banks in January 1984 that the rate of increase of bank lending should be reduced in the following months. He wondered whether warnings would suffice, or whether a change in interest rates might be advisable.

The authorities should not reactivate the automatic adjustment clause for wages and salaries, Mr. Grosche stated. The advantages of a flexible approach to the wage and price setting process should be obvious both to trade unions and to employers. In an environment where the main trading partners were experiencing declining or already low inflation rates, a return by Denmark to indexation schemes that could reinforce inflationary tendencies would prove counterproductive.

On external policies, he was encouraged by the authorities' announcement that they would not use exchange rate policy to reduce the balance of payments deficit, Mr. Grosche said. Their commitment to prudent domestic policies would bring about further progress in reducing both internal and external disequilibria. Finally, Denmark should benefit from the improved economic situation of its neighbors.

Mr. Joyce commented that the stabilization efforts of the Danish authorities since late 1982 had been successful. Through a combination of firm incomes and exchange rate policies and fiscal restraint, inflation had decelerated markedly, international competitiveness had improved, the current account deficit had narrowed, and the growth of the budget deficit had been restrained. With interest rates significantly reduced from their high levels of 1982 and improved business confidence, industrial investment had started to recover, and private sector employment appeared to have stabilized. While the improvement in the overall economic situation and the generally favorable outlook for 1984 were most encouraging, it was clear that Denmark must achieve a lower rate of inflation than its trading partners in order to improve its competitiveness further. The continued pursuit of restrictive demand management and wage restraint policies would therefore be necessary. Given its improved competitiveness, Denmark should be able to take advantage of the favorable external environment and achieve the longer-term goal of reallocating resources to the exposed sector of the economy. Progress thus far toward that objective had been somewhat limited.

He shared the staff's view that the authorities must consider carefully the medium-term prospects, and that they should continue to pursue coordinated fiscal and monetary policies over the next few years, Mr. Joyce stated. Undoubtedly, there would be large political risks in following such a course. However, having met and survived a political challenge recently, it was even more important for the Government to seize the opportunity to improve the competitiveness of the external sector and to reduce further the fiscal deficit. The projected 1984 central government deficit of 9.6 percent of GDP remained high. Further progress in that area was required by emphasizing expenditure-restraint measures rather than revenue-raising ones. Public spending in Denmark was expected to be over 53 percent of GDP in 1984, one of the highest rates in the OECD. Although the share of public spending in any country, or between countries, varied depending on the particular circumstances and social objectives being pursued, Denmark's level of public expenditure was exceptionally high.

The authorities should consider further improvements on the revenue side, particularly in the tax structure, with a view to promoting more incentives and more efficient resource allocation, Mr. Joyce considered. He was referring especially to the progressivity of the income tax and the taxation of profits.

He was also concerned about the level of indebtedness, Mr. Joyce indicated. The authorities had always been able to obtain preferential rates in international financial markets, partly as a result of financial practices that deferred the full costs of borrowing. External debt amounted to 34 percent of GDP, a significant figure. The authorities should not be complacent about their indebtedness or their ability to finance future debt. The large current account deficits incurred in the past were largely responsible for the high indebtedness; the authorities were therefore right in putting emphasis on reducing the current account deficit. They hoped to achieve a current account surplus by 1987/88, but, even under that optimistic scenario, the debt service ratio would still be about 20 percent of GDP in 1988. It was therefore particularly important that the competitive gains of 1983 be maintained and strengthened through 1984 and beyond. Competitiveness should be achieved through cost restraint rather than through active use of exchange rate policy.

The effectiveness of monetary policy had been undermined by problems on the fiscal side, Mr. Joyce observed. While he agreed with the staff that a rise in bond yields would encourage more nonmonetary financing of the budget deficit and would alleviate the short-term problem, the longer-term solution must be to reduce the fiscal deficit.

The authorities should be commended for their continued commitment to wage moderation and their recognition of the need to continue that policy in 1984 and beyond, Mr. Joyce went on. He agreed with the staff recommendations on wage guidelines in the public sector, on the need for permanent abolition of the indexation mechanism, and on the merits of advance announcement of pay policy. An increase in personal income resulting from tax allowances might make the incomes policy more acceptable, but it was relevant to consider how large the tax concessions would need to be to win the support of the social partners. He recognized that income tax reform to improve incentives by reducing progressivity could, in fact, widen the budget deficit.

Finally, he congratulated the authorities on their contributions to international aid, Mr. Joyce stated. The authorities had taken some significant steps toward redressing their economic situation; however, fundamental structural difficulties remained, and they would deserve careful attention in the coming years.

Mr. Caranicas remarked that, since Denmark was a small country with an open economy, heavily dependent on international developments, it had been difficult after the second round of oil price increases for the authorities to increase Denmark's competitiveness and to reallocate resources to the exposed sector by fiscal restraint. In 1981, the Executive Board had recommended that fiscal restraint be supplemented by further modifications in the wage-setting mechanism and a reduction in unemployment benefits. Late in that year, the authorities had introduced measures to strengthen competitiveness and to reduce both the current account deficit and inflationary pressures. Incomes policy had been, and still was, at the core of the Government's program.

The suspension of the automatic escalator clauses for wages and salaries until spring 1985 had been among the most important of the stabilization measures introduced in October 1982, Mr. Caranicas noted. That policy had been instrumental in reducing cost and price inflation. Continued pay restraint would be of primary importance, as both the staff and the authorities agreed. Pay policies beyond 1984 ought to be decided upon and preannounced, in order to reach a broad consensus among the social partners. The issue of wage indexation might not prove to be as crucial as some expected; wages could be restrained through guidelines on public sector pay and an environment of demand restraint. A relatively strong growth in productivity would assist in that respect.

As for fiscal policy, the budget proposal recently submitted to Parliament envisaged a slightly lower public sector deficit in 1984 than in 1983, Mr. Caranicas observed. Such an outturn would be an important initial step in correcting the fiscal imbalances of the Danish economy. The long-standing trend of fiscal expansion should be reversed to restore confidence in the Government's resolve to redress existing problems and to dispel fears that the large public sector deficit was leading to a crowding out of the enterprise sector in the financial markets. The efforts to reduce the growth in public spending should be maintained, given the high interest payments on the accumulated public debt and the rates of taxation prevailing in Denmark. He welcomed the authorities' intention to pursue a policy of fiscal restraint over the medium term. The public sector deficit must be reduced if private sector investment, productivity, and output growth were to be resumed with vigor.

The authorities' exchange rate policy was appropriate, Mr. Caranicas considered. In 1983, the krone had been devalued within the European Monetary System realignment; that correction, combined with a positive cost and productivity performance, had improved Denmark's relative competitive position. He endorsed the authorities' resolve to ensure that competitiveness would be maintained through a moderation of domestic cost-price pressures rather than through an adjustment of the exchange rate.

Denmark's external debt was high in comparison with that of other industrial countries; it had resulted from the continuous current account deficits over the years, Mr. Caranicas commented. The authorities' objective of reducing the debt burden over time was appropriate. Based on the staff's debt scenarios, which indicated the magnitude of such a stabilization effort, a rate of growth of domestic demand of about 2 percent annually during 1985-88 would enable the Government to achieve its goal of a current account surplus within four years. Growth of domestic demand at a higher rate would lead to continued, although smaller, external deficits.

By implementing their adjustment policies with perseverance over the next few years, the authorities might be able to overcome adverse conditions and political difficulties, Mr. Caranicas said. As the Managing Director had stated on Febrary 6, 1984, "Experience showed clearly that those countries where the implementation of adjustment measures has been sustained over a period of years have generally been more successful in moving toward a better external position and a stronger overall economic performance." The adjustment efforts of the Danish authorities during the past few years were in line with such a principle and deserved commendation.

Mr. Clark stated that he endorsed the general thrust of the previous interventions by Executive Directors. The staff could usefully have included in its paper further analysis of recent productivity performance, especially in terms of the structural and cyclical components. On the supply side, the authorities should emphasize product development and diversification. He was concerned about the decline in investment over the past decade; there was a need both to reduce the cost of funds and to improve profitability incentives. A fiscal deficit of 10 percent of GDP was too large, and there was an urgent need for the authorities to take action in that regard. As for incomes policy, he hoped that there would be no reintroduction of wage indexation. On the external front, he welcomed the relaxation of exchange controls on foreign borrowing and lending. He shared the staff view that the authorities' current account objectives were unlikely to be achieved unless growth in domestic demand were held below that of Denmark's trading partners. Finally, Denmark had made a start in tackling its problems. The most pressing need was for the authorities to bring the public sector deficit firmly under control, a move that would help both to limit the current account deficit and to curb the growth of the monetary aggregates.

Mr. Feito commended the authorities for having arrested the dangerous trends that had characterized Denmark's economic performance after the second round of oil price increases. During the period 1979-82, the cumulative imbalances had resulted in high levels of both public domestic debt and total external debt, which had made it difficult for the authorities to prevent the economy from deteriorating very fast. The growing public sector deficit and dissavings had limited the overall propensity to save; consequently, the authorities had resorted increasingly to foreign borrowing, and the external debt had grown rapidly, resulting in a rather high debt service ratio for an industrial country. Against that background, the authorities' success in improving the economic situation had been impressive. Undoubtedly, it could be argued that they could have achieved better results in some areas, but the process of adjustment had just begun. He commended them for the economic rationale behind the stabilization package.

With respect to the authorities' policies on the areas of exchange rate and competitiveness, Mr. Feito went on, neither a real devaluation nor lasting competitiveness could be secured by nominal exchange rate changes in a framework of downward inflexibility of real labor costs. The authorities' policy of increasing competitiveness by restraining domestic costs of production rather than by manipulating the nominal exchange rate was effective. As a result, domestic and external imbalances had been corrected significantly, and the balance between unemployment and the external current account had improved. Without the moderation in overall labor costs and the improvement in wage differentials--owing to the suspension of wage indexation--the reduction in the current account deficit by the equivalent of 2 percent of GDP would have caused unemployment to increase by more than 0.5 percentage points. Alternatively, without wage moderation, the rate of unemployment of 10.5 percent would have resulted in a much higher external imbalance. The balance of payments position and the rate of inflation demonstrated the success of the authorities' strategy, which should help to secure continued acceptance of wage restraint by the population. In the medium term, however, labor cost moderation would be difficult to ensure if unemployment were not reduced.

Wage moderation in an economy such as Denmark's would reduce unemployment in the short term owing to its beneficial effects on the external balance, Mr. Feito stated, although the impact would depend also on the policy mistakes of other countries and Denmark's previous policy mistakes. In any event, the positive impact on unemployment would not be sizable. In a medium-term and longer-term perspective, the grim unemployment situation in Denmark was closely related to the poor performance of fixed investment. Although many factors were responsible for the low level of fixed investment--including past wage policy--the high real interest rates were incompatible with full-employment flows of capital formation. In that respect, he shared the staff's view that the authorities should give priority to reducing the budget deficit in order to lower real interest rates. It was encouraging to note from Mr. Tvedt's statement that the authorities were well aware that the current level and structure of the budget deficit posed great danger to economic recovery. Even assuming the best fiscal scenario, there was little room for the authorities to reduce real rates of interest, given the world financial environment:

external factors largely determined the levels of domestic nominal interest rates and inflation rates, thereby imposing limits to domestic real interest rates. Any pickup in domestic investment would be short-lived if internationally determined real interest rates did not decline rapidly enough to encourage the conversion of financial capital into fixed capital, and it would prove difficult to prevent wage increases and the eventual restoration of the full indexation system.

On the economic impact of increased oil and gas production over the next four years, Mr. Feito went on, it must be kept in mind that a boom in the traded goods sector did not necessarily have a positive effect on the economy. In a number of cases, a rapid increase in production in the traded goods sector had induced a real appreciation of the exchange rate and an increase in domestic demand, thus squeezing profits in other sectors. The authorities should pursue a cautious policy to prevent the oil and gas sector from growing at the expense of other sectors producing tradable goods. A slower growth of domestic demand in Denmark relative to its trading partners would therefore be required. It was also essential to pursue a flexible wage policy that would reflect the different economic conditions and prospects among sectors. Although the functioning of the wage-bargaining mechanism seemed to have improved significantly, the current growth of nominal demand was a cause for concern. The authorities should try to bring the growth of nominal demand under control now that the wage indexation scheme was no longer in place. Fiscal policies should be tightened, or otherwise the authorities would have no alternative but to accommodate the growth in wages. In conclusion, he warmly commended the authorities for their commitment to development aid despite the mounting budget difficulties.

The staff representative from the European Department stated that a more detailed analysis of Denmark's tradable goods sector had been included in previous staff reports. That sector had remained relatively small: manufacturing output had amounted to 19 percent of GDP in 1982, compared with an OECD average of about 26 percent of GDP. The public sector had pre-empted an increasing share of domestic resources, and crowding out of the manufacturing sector in the financial markets might also have occurred as a result of the large budget deficit and high real interest rates. Clearly, the tradable sector needed to be strengthened in order to achieve a stable balance of payments position, while increasing employment. To that end, increased investment in the tradable sector would be required. Although there had been some improvement in that respect, it was difficult to determine precisely from the statistics the extent of that improvement. Data on private financial flows could not be broken down between households and businesses, and estimates for 1983 were not yet available. It was evident, however, that the counterpart to the improvement in the current account deficit in 1983 had been an increase in domestic savings as a result of reduced dissavings by the public sector. Gross profits as a percent of sales were estimated to have risen from about 3 percent in 1980 to 4.2 percent in 1982, according to figures included in the report on recent economic developments. Although data were not yet available for 1983, a further improvement was believed to have taken place in that year. Nevertheless, in the early 1970s, gross profits as a percent of sales had been significantly higher, at about 5.5 percent.

Private estimates on profitability also confirmed improved profitability in the industrial sector, the staff representative continued. According to those estimates, covering only part of the manufacturing sector, profits in relation to equity capital had risen from about 12 percent in 1980 to more than 17 percent in 1983, a rate higher than the yield on bonds. The increased profitability in 1983, together with the lower cost of capital as a result of lower interest rates and the recovery of demand, had led to a turnaround in business investment. Despite the recent improvements, further progress was necessary. The latest forecasts suggested that business investment outside the oil sector would rise by about 12 percent in volume terms in 1984. Further improvements in profitability were to be achieved primarily through continued wage restraint. The staff considered that restraints on public spending and reductions in the public sector deficit would be crucial for the freeing of resources for investment.

As for the labor market, the staff representative went on, lack of mobility seemed to be less of a problem in Denmark than in some other countries, as evidenced by the relatively strong productivity performance during the recession. With respect to the observation that perhaps increased female participation rates had contributed to the rise in unemployment, female participation rates had also risen when household incomes had been under a squeeze. Freezing unemployment benefits, which would lead to a fall in benefits relative to wages from about 85 percent in 1982 to about 75 percent in 1984, should increase incentives for women to increase labor supply.

The authorities hoped to reduce the budget deficit steadily, with the aim of improving the external current account position and encouraging the desired recovery in private investment, the staff representative remarked. Fiscal adjustment, begun in 1983, would be continued in 1984, and although the staff had presented in its papers the official medium-term fiscal estimates, fiscal policy beyond 1984 was not yet firm. The more optimistic the assumptions behind those estimates proved to be, the greater would be the degree of fiscal adjustment required.

The staff had also referred to the authorities' plans for tax reform, particularly with respect to income tax, the staff representative from the European Department pointed out. The timing of the implementation of those reforms was unclear. Certainly, the authorities did not intend to increase the tax burden over time. However, the major emphasis of fiscal policy should be on the expenditure side.

The Chairman remarked that it was clear from Chart 2 of SM/84/3 that a rapid increase in public consumption had crowded out fixed investment. The consequence of that situation had been the accumulation of debt problems.

The Deputy Managing Director commented that the government deficit as a percentage of gross private savings had increased from 31 percent in 1980 to an estimated 40 percent in 1983, a ratio twice as high as the ratio in the United States.

Mr. Tvedt stated that the stabilization program introduced at the end of 1982 had been successful in reducing the severe imbalances in the Danish economy. During 1983, the rate of inflation had been halved, and the current account deficit had declined markedly.

Incomes policy, a vital element in the government stabilization efforts, had slowed wage and price increases and had improved competitiveness, while enabling the authorities to maintain exchange rate stability, Mr. Tvedt went on. The policy of wage restraint would be continued, although developments after spring 1985--when the present suspension of indexation came to an end--were unclear.

In the fiscal field, the central government deficit had been DKr 55 billion, or 10.7 percent of GDP, in 1983, rather than the projected DKr 68 billion, Mr. Tvedt indicated. That reduction had been partly a result of a stronger than expected increase in economic activity toward the end of the year. The central government budget for 1984 had not yet been adopted because of the recent election; however, it was the Government's objective to reduce steadily the public sector deficit in relation to GDP, primarily by restraining expenditures.

Many Directors had expressed concern regarding monetary policy, Mr. Tvedt recalled. Admittedly, the money supply had increased sharply in 1983, although a slowdown had occurred in the last quarter of that year. Several factors had accounted for the rise in monetary aggregates, particularly the turnaround in the external account of the private sector and the shift in that sector's liquidity preferences. During a period of marked changes in inflation and interest rates, it was difficult to interpret developments in monetary aggregates. His authorities had preferred to concentrate on the final objectives, such as the exchange rate, which had permitted them to take a more relaxed view regarding monetary developments. They also believed that the role of monetary policy was, to a large extent, limited in small, open economies and that stabilization efforts could be more effective under a stable exchange rate policy. Nonetheless, the Danish authorities had been concerned about monetary developments; the banks had been warned in January 1984 of a possible tightening of their access to short-term liquidity from the National Bank. Moreover, on February 6, 1984 the National Bank had strongly requested the commercial banks to be restrictive in supplying consumer credits. The authorities were monitoring monetary developments closely and were prepared to take prompt action should there be unfavorable developments in the foreign exchange market or an overrapid pickup in domestic demand.

The Danish stabilization program was also aimed at stimulating private investment by improving the general business climate, Mr. Tvedt commented. The growing optimism in the business sector had recently manifested itself in increased private investments, which, together with stronger private consumption, was expected to increase the current account deficit in 1984. During discussions with the Fund in November 1983, however, a further decline in that deficit had been anticipated. The possible deterioration in the current external balance gave reason for concern, and the Government was prepared to take new initiaties to improve the external balance if necessary. The Prime Minister, in his address to the new Parliament earlier in the week, had indicated the authorities' objective of eliminating the deficit over the next four years.

Although impressive results had been achieved in the past 12 months, persistent efforts over a prolonged period were necessary to bring the Danish economy back on track, Mr. Tvedt stated. The authorities were determined to continue their efforts to improve Denmark's competitive position and external balance through wage restraint and firm financial policies, while achieving a needed restructuring of the economy.

Mr. de Vries commented that the difficulties experienced by the staff in analyzing structural aspects of the Danish economy because of the lack of statistics, had also been true in the case of the Netherlands. Both Denmark and the Netherlands had the resources and the manpower to provide statistics. Perhaps the Fund staff should look further into the problem of statistics availability.

The Chairman made the following summing up:

> Executive Directors commended the Danish authorities for the significant progress achieved in reducing both domestic and external imbalances during 1983. The stabilization measures taken in late 1982, centering on firm incomes and exchange rate policies, and the initial steps of fiscal restraint led to a halving of the rate of inflation and a significant reduction in the external current account deficit.
>
> Directors noted that the Danish authorities recognized the need for continued substantial adjustment over the coming years. The long-term decline in the domestic savings ratio from nearly 25 percent in the early 1970s to less than 13 percent in 1982 was seen by Directors as endangering Denmark's growth potential. The net external debt, at over one third of GDP, was considered rather high for an industrial country and required further improvement in the external current account. Directors commended the Danish Government's aim to reach a balanced external current account within the next three to four years, thereby paving the way for a gradual decline in the debt burden. Directors also welcomed the authorities' strategy to achieve the adjustment through domestic demand management and continued pay moderation rather than through an active use of the exchange rate. It was also emphasized that the burden of adjustment should fall predominantly on private and public consumption, rather than, as thus far had been the case, on investment.

Directors noted that the sharp rise in the deficit of the central government budget since the mid-1970s had come to a halt in 1983 and that the 1984 budget envisaged a further reduction in the deficit. Looking beyond 1984, Executive Directors strongly supported the authorities' objective to reduce the deficit year by year, which was seen as a precondition for the desired lowering of real interest rates, which would in turn encourage business fixed investment, and facilitate an expansion of the tradable sector. In view of the high tax burden, Directors emphasized the appropriateness of expenditure restraint, particularly on social transfers, in order to achieve the fiscal objective. Several Directors believed that the pace of reduction of the public sector deficit should be faster than currently envisaged by the authorities.

Directors expressed concern about the recent excessive monetary expansion, which could jeopardize the improvement in the external current account and a lasting decline in inflation. They noted, in this context, that domestic demand was judged to be stronger, and the external account to be weaker than expected earlier. They, therefore, stressed the importance of tightening monetary policy and encouraged the authorities to take measures to absorb the existing liquidity overhang.

Directors emphasized the importance of further dampening domestic wage and cost increases so as to strengthen competitiveness under a stable exchange rate and achieve the needed increase in employment. Several Directors noted specifically that cost and price increases in Denmark would have to remain below those in the country's trading partners if the needed improvement in competitiveness were to be achieved. This would require continued strong guidance in the area of public sector pay, and abolition of wage indexation beyond the spring of 1985. Continued moderation in wage demands after the spring of 1985 and further improvement in the profit position of enterprises, particularly in the exposed sector, were seen by Directors as vital elements in the adjustment process that needed to be pursued in the medium term.

Directors commended Denmark for the recent liberalization of capital controls and the general adherence to the principles of free trade within the obligations of the EC. They also noted with great satisfaction Denmark's development assistance program, which continued to exceed the UN target.

It is recommended that the next Article IV consultation with Denmark be held on the standard 12-month cycle.

## DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/84/19 (2/3/84) and EBM/84/20 (2/8/84).

### 4. MALAWI - CHANGE IN REPRESENTATIVE RATE FOR MALAWI KWACHA

The Fund finds, after consultation with the Malawi authorities, that the representative exchange rate for the Malawi kwacha against the U.S. dollar, under Rule O-2(b)(i), is the midpoint of the buying and selling rates for spot transactions in exchange markets. The Reserve Bank of Malawi will notify the Fund promptly of changes in the rate and advise of any change in the definition of the representative rate for the Malawi kwacha.

Decision No. 7622-(84/20) G/S, adopted
February 7, 1984

### 5. PERU - TECHNICAL ASSISTANCE

In response to a request from Peru for technical assistance, the Executive Board approves the proposal set forth in EBD/84/30 (2/1/84).

Adopted February 7, 1984

### 6. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment set forth in EBAP/84/26 (2/1/84).

Adopted February 3, 1984

### 7. APPROVAL OF MINUTES

a. The minutes of Executive Board Meeting 83/112 are approved. (EBD/84/24, 1/30/84)

Adopted February 3, 1984

b. The minutes of Executive Board Meeting 83/113 are approved. (EBD/84/25, 1/31/84)

Adopted February 6, 1984

8. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/84/25 (2/2/84) is approved.

9. STAFF TRAVEL

Travel by the Acting Managing Director as set forth in EBAP/84/27 (2/3/84) is approved.

APPROVED: July 23, 1984

JOSEPH W. LANG, JR.
Acting Secretary