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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/35

3:00 p.m., March 2, 1984

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

Executive Directors	Alternate Executive Directors
	A. Koné, Temporary
J. de Groote	H. G. Schneider
	X. Blandin
	J. Delgadillo, Temporary
	M. K. Bush
	S. R. Abiad, Temporary
T. Hirao	T. Yamashita
J. E. Ismael	Jaafar A.
R. K. Joyce	
A. Kafka	C. Robalino
G. Laske	G. Grosche
G. Lovato	C. P. Caranicas
	A. S. Jayawardena
	S. El-Khouri, Temporary
	T. de Vries
	H.-S. Lee, Temporary
G. Salehkhou	
	E. I. M. Mtei
M. A. Senior	E. Portas, Temporary
	A. Lindø
N. Wicks	
Zhang Z.	Wang E.

L. Van Houtven, Secretary
B. J. Owen, Assistant

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Also Present

Asian Department: S. P. O. Itam. European Department: P. L. Hedfors, W. L. Hemphill, H.-J. Huss, M. Ishihara, H. B. Junz, P. J. F. Nyberg, M. H. Rodlauer, H. Ungerer. Exchange and Trade Relations Department: S. Mookerjee, Deputy Director; M. Guitian, P. Neuhaus. Fiscal Affairs Department: M. Katz, P. R. Rado. Legal Department: A. O. Liuksila, J. M. Ogoola. Research Department: A. Lanyi. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; J. Gil Diaz, Z. Hodjera, C. M. Loser, J. P. Pujol, L. M. Valdivieso. Advisor to the Managing Director: E. W. Robichek. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: C. J. Batliwalla, K. A. Hansen, L. Ionescu, W. Moerke, G. E. L. Nguyen, Y. Okubo, P. Péterfalvy, D. I. S. Shaw, D. C. Templeman. Assistants to Executive Directors: H. Alaoui-Abdallaoui, J. R. N. Almeida, J. Bulloch, M. B. Chatah, I. Fridriksson, V. Govindarajan, D. Hammann, A. K. Juusela, H. Kobayashi, J. A. K. Munthali, G. W. K. Pickering, E. Portas, M. Rasyid, J. Reddy, D. J. Robinson, A. A. Scholten, S. Sornyanyontr, Wang C. Y.

1. MEXICO - REVIEW UNDER EXTENDED ARRANGEMENT; AND EXCHANGE SYSTEM

The Executive Directors resumed from the previous meeting (EBM/84/34, 3/2/84) their consideration of a staff paper on the review of the performance during the first year, and the program for the second year, of a three-year extended arrangement for Mexico (EBS/84/1, 1/3/84; Cor. 1, 2/29/84; Sup. 1, 1/30/84; Sup. 1, Cor. 1, 2/29/84; and Sup. 2, 2/29/84).

The staff representative from the Western Hemisphere Department explained that the apparent growth in the rate of expenditure by the Central Government in the form of transfers to states and municipalities was the result of legislation establishing a formal revenue-sharing procedure under which such transfers were made automatically in line with the growth of central government revenues. However, at the same time, the authorities had been making an attempt to decentralize spending on education and health by increasing the responsibilities of states and municipalities in those two areas. Thus, although there would be the appearance of growth in central government spending in the form of transfers, there was a corresponding transfer of obligations to local governments.

The distribution of the major subsidies given by the public sector had been shown in Table 65 of the staff report on recent economic developments in Mexico (SM/83/86, 5/17/83), the staff representative continued. Energy, agriculture, education, housing, and industry were the subsidies highlighted. As part of the policy of reducing the size of the overall public sector and its expenditures, subsidies in all those areas were being reduced, but a particular effort had been made to reduce subsidies on energy and in the industrial sector. As for the subsidies implicit in the preferential rates for financial credit, the agricultural sector had benefited the most. Also, there had been an especially large impact on the cost of subsidies arising from exchange losses in late 1982 and early in 1983, but that should be a one-time effect.

The contingency expenditure reserve would only be mobilized, as stated in paragraph 7 of the letter of intent from the Mexican authorities, if public sector revenues exceeded the projections, or if net international reserves were in excess of the targets established in the program, the staff representative noted. The financing would thus have to be available before those contingency expenditures could be released. Evidence also had to be produced to the effect that activity had not recovered.

Agreements on wages were left to collective bargaining between the parties, the staff representative explained. The Government had no direct role, although of course it set the wages of public sector employees, and it was represented on a commission, together with representatives of labor unions and of private enterprises, that set the minimum wage. Needless to say, the position taken by the Government in that commission was influential. In addition, the minimum wage was an important indicator of the likely outcome of wage negotiations, even though it did not have a large weight in the total wage bill. The increase in minimum wages of

30 percent, which had been announced on January 1, 1984, was at the upper end of the 27-30 percent range of the wage agreements negotiated toward the end of 1983. In late 1982, and for a good part of 1983, a large wage adjustment of 45 or 50 percent had resulted from collective bargaining negotiations. Agreements were usually reached for one-year periods. The Government had certainly given a clear indication, on repeated occasions, of its opposition to any policy of wage indexation.

A significant part of the increase in the consumer price index in 1983 was due to two factors, in addition to the underlying inflationary pressures, the staff representative commented. First, large upward adjustments had been made in a number of public sector prices, beginning with prices for all energy products. Second, in January 1983, there had been a broad liberalization of the price control system; it now covered only some 300 categories of prices, whereas until late 1982, it had covered almost all prices. It had to be borne in mind that the rate of inflation had accelerated sharply during 1982, from about 26-28 percent during the previous year to over 250 percent, on an annualized basis, at the end of 1982. The catching up of prices that had taken place early in 1983, when the controls had been released and when public sector prices--particularly energy prices--had been adjusted significantly, had of course been reflected in the consumer price index in 1983. Because it was not expected that there would be a need for similar adjustments in 1984, the rise in the consumer price index should therefore be less marked. Moreover, the inflationary impulses that had been released in 1983 reflected pent-up pressures rather than an underlying rate of inflation due to the pressure of demand and other factors. To the extent that the public sector deficit had been decreasing and that monetary policy had been kept on a tight rein, pressures from the demand side should be abating.

The point of reference for adjustments to the domestic oil price was the international price of oil, the staff representative explained. As an important oil exporter, Mexico was trying to achieve a more efficient allocation of existing resources and, at the same time, a reduction of the previously heavy subsidies on domestic energy products.

The composition of both imports and exports was shown in Table 44 of EBS/84/1, Supplement 1, the staff representative noted. The general trend, through October 1983, was for all imports to fall significantly. Food was not of great significance in Mexico's total import bill, although certain food products, including wheat, were imported on a fairly steady basis. The largest compression had taken place in the import of capital goods, first, because in the very short term, it was easier to postpone such imports, and second, because of the failure of the private sector to invest in 1983. In the near future, and in the medium term as well, the increase in capital investment by the public sector, and in the private sector as well, following the pickup of economic activity, would be expected to lead to a significant increase in capital goods imports in 1984.

As might have been expected, with exchange rate changes of the magnitudes that had taken place since late 1982, there had apparently been a considerable amount of import substitution, the staff representative added. Mexico was after all a large country, with a diversity of economic activities and with considerable industrial capacity. The fall in demand, from the public sector and elsewhere, had left excess capacity in certain sectors, making possible a shift to the production of goods that it had previously not been possible to produce competitively in Mexico. The information needed to make an exact calculation of the extent of import substitution was not readily available at the present time; some import-substitution activities might be of a temporary nature whereas others would probably be more permanent.

As some Directors had observed, even though nonpetroleum exports had been rising at a faster rate in the last few months of 1983 than for the year as a whole, the increase had not been unusually large, at least as measured in U.S. dollar terms, the staff representative noted. There was an effect of a J-curve nature at work; the volume of nonpetroleum exports might be increasing significantly, but because of the devaluation, their value in U.S. dollars might not necessarily rise as much. In addition, the existence of the dual market, and in particular the large differential in the rates at the beginning of 1983, had been an incentive not to report such exports; information from some of Mexico's trading partners suggested that export levels were higher than they appeared to be in Mexico's own statistics. There was no question about the importance of the growth in exports, especially the effect on employment in those sectors of the economy able to take advantage of the situation. The change in relative prices had also affected wages, and labor-intensive activities had become more attractive.

As for the medium-term scenario, in particular in relation to the balance of payments and debt management, the staff representative continued, the servicing of Mexico's external public debt would unquestionably weigh heavily on the economy for some time. Similarly, the crisis of 1982, the capital flight, and the other developments and changes that had ensued would require Mexico to maintain a much higher level of international reserves than had been traditional while it had had easy access to capital markets. The balance of payments projections in Table 10 (EBS/84/1, Sup. 1) were made on the basis of existing debt, whereas the situation could be expected to become more normal than it had been over the past two years. In terms of the increase in exposure of the banks or of external creditors, the figures in the table implied a moderate increase of approximately 5 percent a year for the few years ahead. However, the projections were based on the assumptions of the more pessimistic of the two scenarios in Table 43 of the statistical appendix, in which the current account would be in larger deficit; whether or not that scenario materialized, or the alternative one that assumed a more rapid growth of exports, would depend in part on the authorities' demand management and exchange rate policies. But it would also depend on the prospects for Mexico's nonpetroleum exports. Neither of the scenarios assumed strong rates of growth of exports in real terms; however, the implicit growth rate of from 3 to 5 percent was consistent with the assumptions implicit in the world economic outlook exercise.

The question had been raised about the effect on income distribution and the nature of the economy of implementing the type of adjustment program being undertaken in Mexico, the staff representative noted. Clearly, the objective was to alter in part the structure of the economy. In Mexico, an important aim was to change relative prices, particularly the exchange rate, which would have important implications for the reorganization of economic activities; the measures being taken to eliminate subsidies should also improve the allocation of resources in the economy. Ultimately, the goal was to make the economy efficient enough to generate the necessary foreign exchange to meet balance of payments obligations without running into the kinds of problems that had been faced recently. In the process, certain sectors of the economy, especially those that exported either goods or services, would tend to grow more rapidly than other sectors if the measures being taken were pursued over an extended period. The redistribution of income, rather than of activities, was more difficult to evaluate because of its uneven incidence. In the short run, for instance, all employees in the hotel industry, which was labor oriented, were doing much better than they had been when the exchange rate had been out of line and tourism had been depressed. Other people who made a living from travel, or the purchase of goods, services, or property abroad could no longer do so. Those who depended on government contracts had been affected by the slowdown in economic activity, and those who had benefited from large subsidies were also being affected adversely.

In five or ten years' time, the staff representative considered, if the present policies were maintained, Mexico should be able to sustain a relatively good rate of growth, perhaps not of 8 or 9 percent as in 1981 or 1982, but possibly of 5 or 6 percent, with a relatively low or non-existent rate of inflation. The economy would be much sounder, and those people who were least able to protect themselves from high rates of inflation, which led to economic distortions, would be better off.

The Mexican authorities had indicated repeatedly, in public and in response to the staff's questions, that they did not want to change Mexico's existing foreign investment law, the staff representative from the Western Hemisphere Department stated. The law contained a provision that, in general, imposed a limit of 49 percent on foreign ownership of domestic companies. However, recognizing that it was possible for the Government to relax the limit either for limited or extended periods, the authorities had indicated that they were willing to consider requests for relaxation of the limit on a case-by-case basis. In the revision of the foreign investment regulations, which had been issued on February 17, 1984, certain sectors in which the authorities would be willing to consider such requests were specified. They included those producing machinery, electrical equipment, transport equipment, and electronics; all activities involving advanced technology, such as biotechnology; as well as the hotel industry. If foreign investors were interested in those fields, they could thus receive official encouragement.

The staff representative from the Exchange and Trade Relations Department said that the staff and the Mexican authorities were in agreement on the desirability of the unification of the exchange rates, and on the conduct of exchange rate management to achieve that objective. At the inception of the program for the first year of the extended arrangement, the concern had been to avoid moving too quickly toward unification of the exchange rates. To some extent, it had been considered advisable to give the adjustment policies an opportunity to take hold first; if the move toward exchange rate unification had been made too rapidly, there was a risk that the adjustments in the exchange rates might have only reflected lags in the implementation of policies or lags in the effects of those policies.

The only issue at stake regarding exchange rate unification was one of timing, the staff representative added. The Mexican authorities still felt that the dual exchange rate system was needed as an escape valve. But that was a question of judgment; as Executive Directors had observed, Mexico had already achieved a substantial adjustment, and a good case could be made for more rapid progress toward unification of the exchange rates at the present time. The intention had certainly been to unify them during the period of the extended arrangement. The precise timing, however, would depend greatly on the speed with which the adjustment policies took effect. The proposed decision recommended only that the Executive Board approve the multiple currency practices until the next review of the extended arrangement, the next Article IV consultation, or March 1, 1985, whichever came earlier.

Another staff representative from the Western Hemisphere Department added that during 1983, the exchange rate had been adjusted at a rate that was considerably below the rate of domestic price increase, although it had to be borne in mind that there had been a major depreciation of the rate in December 1982. By the end of 1983, however, the real effective exchange rate was at a more depreciated level than it had ever been in the past decade, except 1977. The expected rate of inflation in 1984 was 40 percent, so that the adjustment in the two exchange rates vis-à-vis the U.S. dollar of Mex$0.13 a day would allow for a depreciation of about 33 percent. Since the expected rate of inflation in the rest of the world was about 4-5 percent, the real exchange rate would remain broadly at the same level as at the end of 1983. The result would be different if account were taken of the recent depreciation of the U.S. dollar vis-à-vis other currencies, a relationship that had an important bearing on the real exchange rate of the peso, but over which the Mexican authorities of course had no control.

As mentioned in the letter of intent, it was the intention of the authorities to eliminate remaining arrears in the course of 1984, the staff representative said. The authorities had actually indicated that they were planning to eliminate all identified payments arrears by the end of March 1984. They had made every effort possible to identify payments that were in arrears, and in 1983, they had established schemes for the repayment of arrears on interest on financial obligations abroad, payments for suppliers' credits, and other private sector obligations. During 1983, payments of such arrears had amounted to just under $1.1 billion, leaving approximately $300 million of arrears to be settled. It would be difficult to know whether or not there were any other arrears in the system, because the authorities had the impression that a number of payments obligations had been settled through the free market, where foreign exchange could be obtained for making any payment; there would thus be no record of whether or not all payments arrears had been settled under the announced schemes. Negotiations were taking place at present with certain official creditor agencies abroad on the terms of settlement of certain other obligations guaranteed abroad, which would not in principle constitute arrears.

Mr. Zhang asked whether the drastic change in the distribution of income in 1983--leaving aside the question of its effect on the allocation of resources--would not lead to a revival of inflation as every income group tried to regain its previous position. It was a question that might have a bearing on future adjustment programs.

Second, Mr. Zhang remarked that the exchange rate policy followed so far had not stimulated exports greatly, and he asked the staff whether further depreciation of the exchange rate would not increase the cost of imports and consequently the cost of living index, thereby also adding fuel to inflationary pressures.

The staff representative from the Western Hemisphere Department replied that whenever there was a sharp change in relative prices, some people would attempt to recoup lost income. As Executive Directors had commented, it was therefore important for the authorities to give the right policy signals, for instance, with respect to the minimum wage and public sector wages, and to maintain the particular set of relative prices that had been adopted. The ease with which the authorities could achieve their objectives would of course depend on the direction of the underlying economic forces, but the Government would also in a sense have to convince the public that it should not try to defeat those objectives. In 1983, the labor unions had cooperated by not engaging in activities that might have threatened the Government's policy.

Exports would continue to grow in volume, the staff representative remarked, but sometimes with a significant time lag. A change in relative prices might well make it possible to produce for the export market, but the private sector had to be given enough time to restructure and to finance the expansion of its activities. Indeed, in 1983, entrepreneurs had had to devote considerable time and attention to settling their debt service obligations. The staff had considered the authorities' scheme for settling obligations incurred before December 1982 to be helpful because it provided an opportunity to restructure private sector debt, thereby enabling entrepreneurs to devote their energies to plans for growth in the near future. All in all, the staff expected exports of nonpetroleum products to grow significantly in the future, as long as there was not a resurgence of protection in the rest of the world. The export projections in the medium-term scenario had been made on a very conservative basis to permit a cautious view to be taken of the prospects for the balance of payments, including debt flows.

The Chairman remarked that the response of the real economy to the change in the exchange rate had been extremely strong. As could be seen from Table 44 in the statistical appendix, exports of manufactures had risen in the first ten months of 1983 to about US$2.3 billion, compared with about US$1.9 billion in the same period the preceding year. Import substitution was proceeding apace, and the tourist sector was booming. It would thus be difficult to contend that the exchange rate change had had no impact on exports and other flows in the balance of payments.

Ms. Bush reiterated the stance taken by her chair on previous occasions on the general issue of augmentation, namely, one of strong opposition to a liberal augmentation policy. An extremely forceful case would have to be made for augmentation to be considered. The resources available to Mexico, and the responsiveness of private markets, tended to suggest that the member should not need to increase its reliance on Fund resources. Furthermore, as many Directors had pointed out, Mexico's debt service ratio was expected to rise over the next few years. Thus, the focus should be on easing the debt load rather than adding to short-term obligations. The generally careful approach described by the Chairman at the previous meeting was therefore appropriate.

Mr. Wicks remarked that he shared Ms. Bush's view that the matter of augmentation should be approached with great caution and, as the Chairman had observed, with an open mind.

Mr. Senior stated that the magnitude of the economic and financial crisis confronting Mexico at the end of 1982, the worst in more than 50 years, had been enormous. There had been an urgent need to improve the balance of payments and strengthen the public finances in order to correct the major external and internal disequilibria in the economy. The program of adjustment adopted by the Mexican authorities during the first year of the extended arrangement--with the support of the Fund--had involved a series of significant policy measures aimed at correcting those major imbalances. That program had embodied a painful but unavoidable major adjustment effort.

Given the size of the imbalances and the sacrifices involved, some Executive Directors had expressed doubts when the Executive Board had approved the program about its outcome, considering that the adjustment might perhaps be too ambitious, Mr. Senior recalled. It was encouraging to note, during the present discussion, that Executive Directors had in general commended the Mexican authorities for the forceful and prompt implementation of adjustment measures that had resulted in substantial progress toward the attainment of the program's objectives. Indeed, the assessment of the program's implementation in the first year had shown impressive results on the external front and in the strengthening of public finances, even though the adjustment had been more severe than originally envisaged.

While the most immediate and acute causes of the economic and financial crisis experienced in 1982 had been brought under control, Mr. Senior continued, there was clearly still a need to continue the adjustment effort in order to place the economy in a better position to achieve sustained economic growth in the future. As the Managing Director had recently stated, in referring to Mexico as an example of a member with an adjustment program supported by the Fund, the progress already achieved and the policies embodied in the second year of the extended arrangement indicated that Mexico was better placed for economic recovery. The significant progress under the first year of the program showed that confidence was being restored and that the adjustment effort was having positive results, thus reinforcing the Mexican authorities' conviction to persevere in their efforts. The better terms of the financial package for 1984 reflected the improved creditworthiness of Mexico and the renewed confidence of the international financial community in the Mexican economy.

Some Directors had referred to the rate of inflation in 1983 as being too high, indicating a possible need for a tighter stance of demand policies, Mr. Senior observed. While it was true that inflation had remained higher than envisaged, it was also true that economic activity had declined much more than initially contemplated in the program. The question that might be asked was what contraction in output--above the 4.7 percent decline experienced--would have been required to bring inflation down to the program target in 1983. The required decline might have been socially intolerable, given the elasticities of output and of the rate of inflation to changes in the exchange rate that he had mentioned in his opening statement. In any case, his authorities were well aware of the need for a further substantial reduction in the rate of inflation, and they had indeed set that goal as one of the highest priorities for the current year. The successful results attained on other fronts, especially in the external sector, should allow for a more favorable rate of change of prices in 1984, because of their effect on expectations and because major adjustments in prices and in the exchange rate had already been made in 1982.

As for the more pronounced fall in real GDP observed in 1983, Mr. Senior commented, it could not be explained, even in part, as had been suggested, by a significant drop in imports due to the restrictive nature of the trade system. Import permits in the significant amount of US$3,000 million had not been utilized in 1983. Thus, the failure of imports to recover had been mainly due to depressed activity in the private sector, as was underscored by the figures on credit to the private sector, which had remained well below the estimates in the program at the end of the year. The replacement of the import permit system by a tariff system was currently under study. However, important policy measures had already been adopted in the first months of 1984, in the continuing process of eliminating import permits and reducing tariffs.

Several Directors had commented on the structural elements of the adjustment program, Mr. Senior noted. The emphasis during the first year had been on short-term demand policies, whereas more fundamental structural reforms were contemplated in the economic recovery program for the current year. Once the immediate causes of the crisis had been overcome, more emphasis could be placed on the structural aspects of the adjustment effort. Since the beginning of the first-year program, important measures had been adopted to deal with some structural problems, including the gradual liberalization of the exchange system, the elimination of subsidies, flexible pricing policies, and institutional changes in the public sector. The program for 1984 placed more emphasis on dealing with structural problems in certain key areas so as to improve the efficiency and allocation of resources. In that respect, as he had already mentioned, the trade system was being reviewed in order to replace import permits by a tariff system aimed at reducing effective protection. The strategy underlying the public sector investment program for 1984, which had received the support of the World Bank, also included relevant structural elements.

The Chairman made the following concluding remarks:

Mexico's outstanding performance reflects the authorities' determination, perseverance, and courage, as well as the cooperation and sacrifice on the part of the country's population. Mexico provides a remarkable example of an adjustment effort that has been supported in a responsible way both by the Fund and by the international financial community.

Very significant results have been achieved with respect to the balance of payments, with a turnaround in the external position that could not even have been imagined a year ago; the management of the economy; the adjustment of the exchange rate; the correction of price/cost relationships; and major improvements on the fiscal side. The program has laid the bases for an economic recovery out of the severe recession generated in the second half of 1982 by the financial crisis.

The economic turnaround already has had tangible manifestations in terms of the country's image in the international markets, as indicated by the recent improvement in the lending terms of foreign commercial banks. Directors observed that the change in the direction of capital movements gave clear evidence of the restoration of creditworthiness, which was certainly a positive factor.

Executive Directors indicated, however, that there was still a long way to go. Clearly, the demand management policies are a very important aspect of the further adjustment called for under the program. Fiscal and monetary policies must be kept on track, and should remain restrained. Inflation has to be curtailed if all the benefits of the restoration of confidence, and of the increase in savings and investment are to be obtained. Directors attached great importance to the authorities' intention to adhere closely to the program. In that respect, the authorities would need to be cautious in implementing the contingent expenditure contemplated in the budget.

The 1984 program has been endorsed by the Executive Board. This program will entail strict adherence not only to the fiscal and monetary parameters, but also to a number of other elements. A key element of the program will be to keep the wage developments in line with the anti-inflationary strategy. The 30 percent increase in the minimum wage agreed upon by the authorities does not leave much room for maneuver, a fact of which the authorities are clearly aware. The authorities also should continue pursuing a flexible exchange rate policy and should move toward the unification of the exchange rate system.

Directors placed strong emphasis on supply-side measures. Clearly, the adjustment program has to develop momentum and move positively toward more structural measures. The measures urged by Executive Directors--to eliminate constraints on pricing; to maintain positive real interest rates in support of savings; to reduce the disparities in lending rates in order to avoid distortions in the allocation of savings; and to intensify the pace of the liberalization of trade and capital movements, with more reliance on tariffs rather than burdensome licensing mechanisms--were all an appropriate part of an adjustment program under the extended Fund facility.

Directors paid considerable attention to the medium-term debt situation of Mexico. I am happy to say in this respect that foreign banks have given the Fund positive indications on the progress of the financing package. More than 90 percent of the resources has been committed by banks. Some further efforts are being made to obtain complete agreement on the package in the coming days. But in the medium term, as Directors rightly noted, the debt profile of Mexico remains unsatisfactory, and substantial restructuring efforts will be required over the years to come; the willingness of creditors to restructure will of course depend on the quality of the adjustment under way. It is thus very important to maintain a conservative demand management policy and to implement fully the structural reforms that can be expected to improve the efficiency of the economy.

It is also important to open up foreign markets for Mexican exports. Mexico's medium-term adjustment will depend very heavily on the expansion of its foreign earnings; the extent of the recovery in the industrial countries and the openness of their markets are therefore of great relevance to the success of the program.

The Executive Board then took the following decisions:

Review Under Extended Arrangement

1. The Fund and Mexico have conducted the review pursuant to paragraph 4(d) of the extended arrangement for Mexico (EBS/82/208, Sup. 4) and as contemplated in paragraph 29 of the letter dated November 10, 1982 from the Secretary of Finance and Public Credit and the Director General of the Bank of Mexico attached thereto, in order to review the implementation of the measures described in that letter, to reach understandings about policies and measures that Mexico will pursue over the program period, and to establish suitable performance clauses for the year 1984.

2. The letter dated January 3, 1984 from the Secretary of Finance and Public Credit and the Director General of the Bank of Mexico, together with the technical memorandum of understanding attached thereto (EBS/84/1, 1/3/84), shall be attached to the extended arrangement for Mexico. The letter dated November 10, 1982, together with the technical memorandum attached thereto, shall be read as modified and supplemented by the letter dated January 3, 1984 and the attached technical memorandum.

3. Accordingly, Mexico will not make purchases under the extended arrangement through December 31, 1984, during any period in which:

(i) the data at the end of the preceding period indicate that the limit on the use of external credit, as specified in paragraph 1 of the attached technical memorandum, has not been observed; or

(ii) the data at the end of the preceding period indicate that the limit on the overall public sector deficit, as specified in paragraph 3 of the attached technical memorandum, has not been observed; or

(iii) the data at the end of the preceding period indicate that the target for the net international reserves of the Bank of Mexico, as specified in paragraph 6 of the attached technical memorandum, has not been observed; or

(iv) the limit on the net credit to the public sector by the Bank of Mexico, as specified in paragraph 2 of the attached technical memorandum, is not observed; or

(v) the limit on the net domestic assets of the Bank of Mexico, as specified in paragraph 4 of the attached technical memorandum, is not observed; or

(vi) the limit on financial intermediation conducted by the national development banks and official trust funds, as specified in paragraph 5 of the attached technical memorandum, is not observed.

4. Until January 1, 1985 purchases under the extended arrangement for Mexico shall not, without the consent of the Fund, exceed the equivalent of SDR 2,206.88 million, provided that purchases shall not exceed the equivalent of SDR 1,304.06 million until May 20, 1984, the equivalent of SDR 1,605.00 million until August 20, 1984, and the equivalent of SDR 1,905.94 million until November 20, 1984.

Decision No. 7638-(84/35), adopted
March 2, 1984

Exchange System

Mexico maintains multiple currency practices and exchange restrictions as described in Section VI of EBS/84/1, Supplement 1. In view of the circumstances of Mexico, the Fund grants approval of these multiple currency practices and restrictions until the completion of the next review under the extended arrangement, or the completion of the next Article IV consultation, or March 1, 1985, whichever is earlier.

Decision No. 7639-(84/35), adopted
March 2, 1984

2. FINLAND - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with Finland, together with a proposed decision (SM/84/39, 2/3/84; and Cor. 1, 2/28/84). They also had before them a report on recent economic developments in Finland (SM/84/48, 2/17/84; and Cor. 1, 2/28/84).

Mr. Lindå made the following statement:

My Finnish authorities are in broad agreement with the staff appraisal. The minor differences of view are mainly due to a somewhat different time perspective.

The preliminary growth figure for 1983 has now been revised upward to 3 1/4 percent and, in the current year, GDP is forecast to grow by 3 1/2 percent. Economic activity is being supported especially by investment demand. According to the preliminary figures for 1983, gross capital formation increased by 4 1/2 percent and the corresponding figure for 1984 is forecast to be 5 percent.

Finnish economic performance in the late 1970s and early 1980s was quite favorable by international standards. While average economic growth over 1978-82 for Finland's main trading partners was less than 2 percent annually, the corresponding figure for Finland was 4 percent. Finland's foreign balance remained in a rather healthy position. The unemployment rate increased noticeably during the 1970s and early 1980s, but relatively less than in most western countries. The rise was, to a large extent, prompted by a strong increase in labor participation, as the number of jobs increased considerably.

The basis for this relatively favorable development was laid in 1977 by the adoption of a medium-term economic program for the period 1978-82. The primary aim of the program was to restore full employment. This goal was to be reached through economic policies in which combating inflation, thereby strengthening the industrial sector, and containing the share of the public sector were major elements. In retrospect, this largely supply-oriented policy, although it failed to reverse the unemployment situation, seems to have been fairly successful. Normally, in a similar situation, Finland would have had a higher inflation rate in relative terms, and a larger external deficit. Admittedly, much of this success was attributable to special factors. The development of bilateral trade with the Soviet Union offset some of the fluctuations in Finland's trade with market economies, as purchases of Soviet oil were largely paid for by increased exports of Finnish products. Moreover, as a result of its export structure, Finland did not experience terms of trade losses as large as those of most other countries. However, one should not exaggerate the impact of such special factors. The developments clearly indicate that a structural strengthening of the economy has also taken place. This is illustrated by the favorable development of investment activity. Finland is actually one of the very few countries that has experienced continuous real growth in fixed investment since 1978. Production technology has been adapted to the changed circumstances through energy-saving measures and new technologies. The exposed sector of the economy has been a forerunner in this respect.

The subsequent developments in 1982-83 showed, however, the limits of how far a small open economy can depart from the path of the rest of the world. Finland's competitive position was slowly eroded, strong speculative pressures built up, and the markka had to be devalued in connection with the Swedish devaluation in 1982. The rate of inflation has, in 1982-83, gradually departed from the average for Finland's main trading partners, and the liquidity of the domestic financial market has increased volatility in capital flows. In the autumn of 1983, an outflow of capital occurred which had to be countered by strong monetary measures, as explained in the staff paper.

Developments in the last year or so have given the authorities a clear signal of the choices ahead. A continuation of expansionary policies would threaten to lead Finland back to the old road of an inflation-devaluation spiral. Adjustments had to be made. It was felt that the cost of adjustment policies would be lowest in a situation where an upturn in the international economy was supporting demand for Finland's export products.

As the staff also points out, reduction of inflation must be the central policy goal at the moment. The Government has set a target for limiting inflation to 6 percent in 1984, which requires that the negotiated wage increases (apart from carryover and wage drift) should be no more than 3 percent. The staff, in its analysis, seems to find these targets somewhat ambitious and doubts whether they can be realized.

With the outcome of the wage negotiations still open, it is difficult to judge whether or not these doubts are justified. However, recent developments on the price front have been rather encouraging. Although the consumer price index went up during 1983, on average, by 8.4 percent, the rise decelerated markedly toward the end of 1983, and in the second half of the year consumer prices rose by only about 5 percent on an annual basis. This development was at least partly due to a slow rise in export and import prices which rose by only 2 percent within the year. Domestic producer price indices, which can be considered to reflect the underlying pace of inflation, are also down to about 5 percent. In fact, the Ministry of Finance has, in its latest forecast, lowered its price estimates from 8 percent for 1984 (a year-on-year average corresponding to the above-mentioned 6 percent within the year) to 7 percent. These facts would indicate that the difficulties of reaching the inflation target might be overestimated in the staff report. Clearly, however, inflation remains an issue of great concern for the authorities.

A great deal will, of course, depend on the results of the wage negotiations. Those between the labor market parties are now in a critical phase and the next few days, or weeks, will be decisive. The Government and the Bank of Finland have clearly indicated that they are prepared to further tighten policies should the income settlements not conform with the inflation targets.

Furthermore, there is no doubt that a prerequisite for a permanent reduction in inflation is a deceleration in monetary expansion. As the staff points out, active steps have been taken to this end since early 1983. The measures that took effect at the beginning of 1984 represent a considerable tightening in the domestic monetary policy stance. However, at the same time, a brisk inflow of short-term capital has led to a rapid increase in foreign exchange reserves, which has enabled the monetary expansion to continue at a rate that the authorities conceive to be excessive. Consequently, further measures have been deemed necessary, and most recently the banks' cash reserve requirements have been increased from 4.7 percent to 5.0 percent as from the end of February.

Monetary policy instruments have been developed to take into account the recent evolution of the financial market. In this connection, the authorities welcome the suggestion made by the staff for developing the monetary policy framework. It is no doubt imperative to improve the transmission mechanism of monetary policy, and further measures will have to be taken. However, a considerable amount of unknown ground will have to be covered and the authorities feel it is appropriate to move rather cautiously.

As far as present interest rate policy is concerned, the central aim of the authorities is to secure a clearly positive real interest rate. Implications of this goal for the nominal interest rate will be dependent upon the rate of inflation. If inflation decelerates in line with targets, as indicated by recent price developments, the authorities do not see any need for raising nominal interest rates from their present levels.

Fiscal policy has, in the last couple of years, been supportive of the expansion of the economy, as reflected in some weakening of the financial position of the public sector. Obviously, at the present juncture, restraint is called for to support the fight against inflation, and, in that way, to create room for maneuver in the downturn.

The future prospects of the Finnish economy, however, do not depend on the success of domestic economic policies alone. Developments in Finland's major trading partners are also of prime importance. For a small and very open industrial economy, the maintenance of the free trading system is of vital importance. Even the best efforts of the domestic policymakers are bound to fail if the international economy stagnates and protectionist barriers are erected. Therefore, my Finnish authorities stress their commitment to the principles of free trade. External imbalances in national economies have to be countered by consistent domestic adjustment policies where trade-restricting measures have no place.

Mr. Lovato said that if he understood the staff papers correctly, the Finnish authorities had set the reduction of inflation and the improvement of competitiveness as their long-term objectives. But in the past two years, at least until mid-1983, they had adopted a reflationary economic stance in order to boost activity and to reduce unemployment. They had succeeded in increasing GNP by about 2.5 percent a year. However, the modest gains in the fight against inflation and the rise of unemployment demonstrated once more the limits of a policy that did not take the international environment into consideration.

All in all, Mr. Lovato remarked, the Finnish authorities had done relatively well, and they were to be commended for the objectives they intended to pursue in the long run, for their support of a liberal international trade system, and for their efforts to increase official development assistance.

Certain trends were present in the economy that had been innocuous so far but that could become potentially dangerous, Mr. Lovato continued. An improvement of external competitiveness was an important objective, the more so for an open economy, yet in 1983, contractual wage and salary rates had risen on average by 8 percent, and the overall average increase in wage and salary earnings had been 10 percent. Thus, gains in labor productivity were still being outstripped, and unit labor costs for the economy as a whole had increased by 7 percent. What was even more worrisome, unit labor costs in the forestry sector, the most important export sector, had been rising. Unfortunately, although the indexation system had officially been dismantled, in practice it still existed in the form of the earnings guarantee clause. Even in 1983, according to the section on fiscal policy in the report on recent economic developments, provision had been made for "additional expenditures designed, in large part, to help further offset the adverse effect of the devaluation on incomes, particularly of households...." Although that attitude was understandable from a social point of view, it tended to perpetuate the inflationary momentum and to aggravate the public sector deficit.

Therefore, Mr. Lovato added, he agreed with the staff that the current wage negotiations were crucial. He would encourage the authorities to set public wages first rather than following wage negotiations in the private sector. Unsatisfactory wage agreements could exert pressure for new exchange rate changes, which in turn would prolong the usual cycle of inflation and devaluation.

Outstanding public debt was manageable, Mr. Lovato considered, and the objective of giving adequate scope and encouragement for private sector investment in export-related activities was commendable. But the reduction of the tax burden on enterprises was supposed to have been matched, at least to some degree, by attempts to rein in the growth of public sector spending. As a matter of fact, besides the pressure emanating from the expansionary measures taken toward the end of 1982, supplementary budgets had provided for additional expenditures in 1983 to strengthen employment programs and expand agricultural subsidies. While outstanding public sector debt was not high enough to create problems for the time being, it could become worrisome because of the inadequacy of the savings ratio.

The Finnish authorities, although they had used different instruments, had so far conducted monetary policy in a very efficient way, Mr. Lovato noted. He welcomed the simplification and improvement of the monetary mechanism, which could help to tighten monetary controls, but there was still a need to change the structure of interest rates, which were too low and negative in real terms. A more flexible interest rate policy was bound to influence both the savings ratio and the demand for credit.

Mr. Laske commented that the Finnish economy had weathered more successfully than other industrial European economies the series of real and monetary shocks to which the world economy had been exposed over the past five to six years. Although the rate of inflation continued to be high, and unemployment remained at an uncomfortable level, Finnish policies appeared to be addressing the country's problems in a well-coordinated way.

Finland's growth rate had outpaced the average rate of growth of its major trading partners during the past few years, Mr. Laske observed; special factors might have played a role, as Mr. Lindå had pointed out. The medium-term economic program for the period 1978-82 had proved to be a sound basis for that rather successful development. But the staff report conveyed the impression that in the more recent past, the conduct of economic policy in Finland had become guided to a greater extent than in the past by short-run considerations, especially with respect to demand management policy. In 1982, despite the relatively high inflation rate of about 10 percent, the authorities had decided to embark on an expansionist course, which had proved one year later to be somewhat too stimulative. The evidence was the deterioration in the current account of the balance of payments and quite strong wage increases. In the wake of those developments, the policy stance had had to be adjusted again, in a stop-go fashion. Another question that could be raised was whether the reductions in contributions to the social security system, which had been enacted in 1977, conformed with the medium-term and long-term requirements of the economy. In the short run, cost pressures in the private sector had been eased, but in the longer run, the public sector deficit was likely to be increased and, consequently, the Government's demands on the capital markets. Thus, it remained to be seen whether those reductions in social security contributions would have the desired lasting impact on the labor market and on growth prospects.

The authorities should therefore consider reformulating their policies within a medium-term framework, Mr. Laske suggested. He recognized that they would have to consider that Finland had a relatively small, open economy, which was closely integrated into the world economy and had important ties to a large centrally planned economy. The vulnerability of the economy to sudden exogenous shocks thus called for flexible policy formulation and implementation.

Useful information was provided in the report on recent economic developments on the intricacies of financial markets in Finland and the problem of monitoring and guiding them, Mr. Laske observed. It seemed easy to conclude that the regulations were so heavy as to overregulate those markets. The emergence of a "gray" or semiorganized market in financial assets supported that conclusion. Greater freedom for the forces of supply and demand in the determination of the kinds of transactions and assets supplied could, in his view, strengthen the authorities' control over the financial markets and over financial developments, rather than dilute them as the authorities might fear.

A closely related aspect was that the central bank was confined to influencing the profitability of banks by varying the cost of refinancing, Mr. Laske commented. The Bank of Finland might thus be underequipped with monetary tools, having no means at its disposal to steer directly the liquidity of the banking system. In addition, the central bank probably had little power to control the money supply, which might explain the periodic inflationary excesses from which Finland had suffered over the years. Therefore, he would encourage the authorities to consider placing additional policy tools in the hands of the central bank to enable it to control monetary developments more effectively, perhaps increasing at the same time the efficiency of the financial markets.

In order to bring down the rate of increase in prices during 1984 to 6 percent, Mr. Laske noted, the Finnish authorities had stated that wage increases should be kept within a limit of 3 percent. It was a laudable target, but he concurred with the staff view that it seemed ambitious because it would imply a reduction of real wages. The wage negotiations that were getting under way would thus be crucial for economic developments over the coming months, and they certainly entailed a fair amount of uncertainty. The authorities might eventually be faced with a strong rise in wages and costs, should the outcome of those negotiations be unfavorable. The question would then arise of what action the authorities could take to avoid breaching their inflation target.

Finally, Mr. Laske said that he was in agreement with the proposal to keep Finland on an 18-month Article IV consultation cycle.

Mr. Schneider observed that, in general, the economic performance of Finland over the past five to six years had been relatively favorable. In spite of the openness of the Finnish economy and its dependence on the foreign sector, economic developments had by and large been better than those in a number of other industrial countries. The economic prospects for 1984 also looked promising. However, the attempt of the Finnish authorities to compensate for unfavorable prospects in 1982, by combining more expansionary monetary and fiscal policies with their long-standing supply-side oriented policy, had more or less failed. The inflation differential vis-à-vis Finland's main trading partners, and the ensuing erosion of the Finnish competitive position, had once again led to a devaluation of the markka in October 1982. In saying that, he was aware that the second devaluation in the month had been triggered by the 16 percent devaluation of the Swedish krona. In order to break the inflation/devaluation cycle of the postwar period, the Finnish authorities would have to deal with the main underlying cause--inflation.

Although he fully understood the preoccupation of the authorities with the rise in unemployment, Mr. Schneider continued, he agreed with the staff that it was essential for Finland to keep its inflation rate at least in line with that of its main trading partners in order to avoid further loss of competitiveness. To achieve that goal, the outcome of the ongoing wage negotiations would be of crucial importance. He asked whether Mr. Lindå or the staff was already in a position to indicate the possible results of those negotiations.

As pointed out by the staff, as well as by Mr. Lindå the authorities were aware of the problem, and were about to adopt a medium-term economic policy strategy, Mr. Schneider added. He would encourage them to follow with determination their "active" economic policy, which was described on page 8 of SM/84/39, because he believed that the inflation/devaluation cycle mentality was deep-rooted and could only be tackled in the medium term. In that context, he wondered whether the Government could not play a more active role in the wage negotiation process, beyond the setting of targets that were, if he was not mistaken, not binding.

The slightly restrictive stance of fiscal policy in 1984 was all the more welcome and important because it was at least a modest contribution to the fight against inflation, Mr. Schneider considered. Admittedly, as in many other cases, the room for maneuver seemed to be rather limited, but he had noted that transfer payments accounted for a sizable 57 percent of total expenditures in the 1984 budget. In addition, more could be done to deregulate and simplify the financial system, which appeared to be rather complex according to the description on page 10 of the staff report.

He joined the staff in welcoming the important monetary measures implemented by the authorities at the beginning of 1984, Mr. Schneider mentioned. Events in the autumn of 1983 had amply demonstrated how important a determined and flexible interest rate policy could be. Nevertheless, it seemed necessary to broaden further the scope of monetary instruments as well as to improve the transmission channels for monetary policy, all the more so because the main burden in the fight against inflation would have to be carried by monetary policy, especially if the outcome of the current wage negotiations was a higher than desired settlement.

The principal aim of exchange rate policy should be to keep the nominal effective rate constant in terms of the index applied, Mr. Schneider considered, especially in view of the thinness of the exchange market, which had even prevented the Bank of Finland from making discretionary changes in the exchange rate. However, an important precondition for achieving that aim over the longer run was an inflation rate that was at least no higher than the average inflation rate of those countries whose currencies were taken into account in calculating the currency value of the markka.

Finally, Mr. Schneider said that he supported the proposed decision as well as the proposal to hold Article IV consultations with Finland on an 18-month cycle.

Mr. Joyce recalled that when the Finnish economy had last been discussed in the Board in January 1982, all Executive Directors who had spoken, including himself, had congratulated the authorities for their better than average growth rates over the previous two years, achieved despite the oil shock in 1978 and 1979 and the subsequent world recession. In reality, the economy had been even more buoyant than expected, and overall fiscal and monetary policies in 1982 and 1983 had been too expansive.

Finland had reaped the consequences; a deteriorating balance of payments situation and large speculative outflows of capital. The corrective measures taken by the authorities had not been too successful. True, the first devaluation had been undercut by the large subsequent devaluation of the Swedish krona. But efforts to induce workers not to make high wage demands had failed, despite concessions on the part of the state in other areas. In the meantime, the rate of inflation had again begun to increase.

Additional effective measures had since been taken, Mr. Joyce continued. As long ago as the autumn of 1983, the authorities had raised interest rates to stem further capital outflows. The Government had set a target to limit inflation to 6 percent in 1984. Further monetary restrictions had been introduced to back up those measures, and the authorities had indicated their clear intention to pursue a more restrictive fiscal policy, aimed at reducing the Central Government's deficit. The question was whether those policies would work. In the past, the Finnish authorities had been too optimistic, both about the effectiveness of monetary action and about their own ability to restrain wages. The outcome of the current wage negotiations would be instructive.

He was concerned, like Mr. Laske, that the Finnish authorities' policy had been too responsive in recent years to short-term demands and not sufficiently responsive to the short-term consequences, Mr. Joyce remarked. Such a stance clearly tempted fate, and he was happy to note that the authorities were determined to tighten their policies. The test would of course be their response, should wage increases exceed the 3 percent target.

Developments over the past two years raised in his mind the question of the appropriateness of an 18-month cycle for Article IV consultations with Finland, Mr. Joyce stated. He wondered whether the proposal to continue that cycle reflected the wishes of the Finnish authorities, or whether the staff saw no need for more frequent consultations.

Finally, Mr. Joyce noted that the Executive Board was being asked to approve, until January 31, 1985, Finland's remaining bilateral payments arrangement with a Fund member; there were still bilateral payments agreements with three non-Fund members. The authorities intended to discuss the termination of the agreement with Hungary in the autumn of 1984, but he wondered what would happen if it was not in fact terminated by January 31, 1985.

Mr. de Vries remarked that in each of the past five years, Finland had witnessed more favorable economic results than its main trading partner countries, in terms of real growth, industrial production, and employment, and without encountering really serious fiscal and external imbalances. Those welcome developments seemed to be due in large part to the medium-term program adopted in 1977. It was clear however from the staff reports that the Finnish economy had been run almost at the limit, as it quite often had been. The limit seemed to have been reached, and some of the necessary measures had been taken; the question was whether they were enough.

The major constraining factor, Mr. de Vries observed, was the balance of payments, with a deficit of about 2 percent of GDP. He took as relaxed a view of a deficit of that magnitude as he had of the surplus of the same size of another country discussed recently by Executive Directors, some of whom had been led to conclude that such a surplus indicated serious imbalances in the economy in question. Nevertheless, the disequilibrium in Finland's external account could not be allowed to worsen. The Finnish authorities had taken some measures, but there must be some reason why they were not developing a new medium-term program, given the success of the previous one.

The budgetary policy stance had been too expansionary in the past two years, Mr. de Vries continued, and again, the question was whether the measures taken went far enough. Monetary policy seemed to call for special attention at the present time. Mr. Lindå had stated that the prerequisite for a permanent reduction in the rate of inflation was a deceleration in the rate of monetary expansion. But there was considerable doubt as to whether or not the authorities had enough instruments to keep monetary expansion in hand, as the staff and previous speakers had commented. The authorities themselves had found it necessary to take some measures, but he would encourage them to be less cautious in equipping the Bank of Finland with adequate instruments to exert effective control over the creation of domestic money and liquidity.

Wage rates under the present negotiations should not be increased by more than 3 percent, Mr. de Vries remarked, because of the need to allow for wage drift and carryover. Real wages would thus not be reduced by very much. The question was how the authorities would respond if the outcome of the negotiations was not in conformity with the target, given the importance of dealing with inflation. He had noted with great interest that in Finland, as elsewhere, the lowering and subsequently the stabilization of the share of labor costs in national income had gone hand in hand with an improvement in the employment situation.

In sum, Mr. de Vries considered that the Finnish authorities should be encouraged to pursue their pragmatic mix of demand management and structural adjustment in order to regain some room for maneuver in the coming years. Like Mr. Joyce, he felt that the authorities were again at a crossroad. While the consultation cycle depended on the various priorities assigned by management, he wondered why an 18-month cycle had been proposed for the Article IV consultation with Finland, and whether there was any room for adjusting it.

Mr. Wicks joined others in noting the steady rate of growth of the Finnish economy over the past few years, which had been above the average growth rate of its trading partners. The open trading system made the economy particularly vulnerable to external shocks that were not always easy to absorb smoothly, and it had not yet fully recovered from the shock experienced in 1982. The Finnish authorities should be encouraged to adopt a medium-term policy stance again, as Mr. Laske and Mr. Joyce had indicated; Mr. de Vries had also recalled that they had followed a similar approach in the past with signal success. It was not certain that the present policy stance would achieve the objectives the authorities had set for themselves, and for two reasons. First, the way in which wages were set at present might not be consistent with achieving lower rates of inflation and the maintenance of international competitiveness that was so rightly desired by the authorities. Wage determination was an important and perhaps crucial area of economic policy.

Second, according to the foreign debt projections in Appendix I of the staff report, net external debt as a percentage of GDP would hover around 17 or 18 percent over the medium term, Mr. Wicks observed, but as shown in the footnote the figure could be higher by 3/4 of 1 percentage point. The Finnish authorities believed that a ratio of external debt to GDP of up to 20 percent was manageable. Because changes in current account developments could clearly have a significant effect on the external debt position, a less favorable outcome than had originally been projected would bring the ratio quite close to 20 percent, another development that might usefully be looked at in a medium-term policy perspective.

As the staff had advised, Mr. Wicks continued, there was a need for higher interest rates in view of the strong unsatisfied demand for credit that was evidenced by the rapid growth of the "gray" market. The measures taken in 1983 to simplify central bank lending should help to integrate that market into the officially regulated market. However, according to the staff's apparently conservative estimate, the "gray" market had grown to a size equivalent to about 15 percent of the regulated sector. He would be interested to know whether the authorities had any further plan to unify the two markets or to open up the regulated market so as not to have two markets operating simultaneously.

As mentioned in the report on recent economic developments, Finland had a five-year trade and payments agreement with a large country that was not a Fund member, Mr. Wicks observed. He had noted with particular interest that when a surplus in excess of the specified limit had built up in Finland's favor at the end of 1982, Fmk 2 billion of the surplus had been converted into a medium-term loan, on which Finland was to receive interest from the country concerned in the form of commodities. The question was whether such a large-scale extension of credit abroad was consistent with the optimal use of resources, especially in light of Finland's own relatively heavy foreign borrowing. He was the first to recognize that it was a sensitive issue, but he would be interested to have the staff's views on the prospects of Finland reversing the operation in the medium-term future.

Referring to the cycle for the Article IV consultation with Finland, Mr. Wicks recalled that more than two years had elapsed since the previous consultation. Thus, an 18-month cycle would be an improvement, and he would be prepared to accept its continuation, on the understanding that an Article IV consultation could be held earlier, with the agreement of the Finnish authorities, should there be any adverse developments. He had in mind a resurgence of inflation, wage pressures, or balance of payments difficulties.

Ms. Bush said that, like Mr. Laske and Mr. Wicks, she had some concern about the unregulated "gray" market, and she wondered whether the authorities were considering any additional market-oriented means of restraining the growth of liquidity. Despite the weakness of the structure for managing monetary growth that had been pointed out by the staff and by many Directors, she also wondered whether the Finnish authorities were giving any consideration to trying to lower the rate of growth in the monetary aggregates and to establish a policy of targeting. In that connection, she had noted that M-1 and M-3 had continued to rise in 1983.

She had noted with approval the forecast annual rise in central government expenditures of only 6.5 percent in 1984, Ms. Bush continued. The staff expected the deficit to be brought down even further to 2 percent of GDP. However, she was concerned about the practice of resorting to supplemental budgets, which might again raise expenditures and the deficit. She wondered what steps the authorities might plan to take to achieve their budget goal without tax increases or raising the ratio of the deficit to GDP.

Finally, Ms. Bush said that she concurred with Mr. Wicks's view that the 18-month cycle still seemed to be appropriate but that, if difficulties arose, consideration should be given to holding the Article IV consultation sooner.

Mr. Portas commented that he was in broad agreement with the staff appraisal of economic developments in Finland during the past two years. Economic prospects for 1984 were quite favorable and an improvement in relation to the previous years. Inflation remained the basic problem of the Finnish economy, given its size and openness to the external sector. The authorities would have to deal with that issue firmly if they were to retain the country's international competitiveness and avoid a further devaluation of the Finnish currency. In that respect, a prudent wage policy and understanding between the social partners were necessary.

The monetary measures introduced at the beginning of 1984 were welcome, Mr. Portas considered, not only because they signified a more restrictive policy stance but, just as important, because of the signals they gave to different sectors and their effect on expectations. A correspondingly prudent fiscal stance could not help but achieve the authorities' objectives.

To conclude, Mr. Portas commended the Finnish authorities for increasing their official development assistance in recent years.

Mr. Mtei stated that as a number of Directors and Mr. Lindå had recalled, the Finnish economy had responded well to the difficult external economic environment in 1979-80, which had been caused mainly by the second oil price shock. However, the experience in the past two years had been mixed. While economic activity had been comparatively stronger than that of Finland's trading partner countries in western Europe, inflation and unemployment had risen, and the external sector had weakened.

An expansionary fiscal and monetary policy stance had been designed to counter the sluggish growth of output that was in prospect, in the hope also of reducing unemployment, which had been rising to intolerable levels. As it had turned out, GDP had risen more strongly in 1982 than in the previous year, and according to the information given by Mr. Lindå, it was expected to show even stronger growth in 1983.

However, the increase in output had failed to halt the rise in unemployment, Mr. Mtei continued, in part because of the increase in participation rates. The gains that might have been made had been forestalled by the demographic factors outlined on page 7 of the report on recent economic developments. It also appeared that the sectoral distribution of the growth in output, which had favored the services sector, coupled with high wage settlements, might have eliminated prospects for employment gains. Could the staff comment on whether or not the wage settlements, which it had characterized as "disconcertingly high," had affected the employment situation?

By highlighting those points, Mr. Mtei remarked, he had felt that some useful lessons could be drawn from the Finnish experience with stimulating the economy in the face of weak growth prospects and the persistence of the international recession. As Chart 1 of the staff report demonstrated clearly, Finland's trading partner countries had been faced with a similar, if not more difficult, situation. As he had already indicated, the impact of expansionary policies on prices and the external sector had been somewhat adverse, and the authorities were anxious to put an end to the inflation/devaluation spiral. However, he believed that the economy had performed relatively well under very difficult external conditions. Perhaps the real test would be in the response of the economy to the measures that had been put in place to restrain monetary and fiscal expansion.

He also believed that the gains in output growth might have induced a reduction in the rate of unemployment, had it not been for the countervailing forces to which he had already referred, Mr. Mtei added. In the period ahead, the anticipated moderation in wage settlements and the strengthening of output growth could halt the deterioration in the unemployment situation, which would help at the same time to contain inflationary pressures. In fact, as Mr. Lindå had explained, the target rate of inflation might not be so ambitious after all. The lesson to be drawn was that some expansion might be advisable for those countries that had made significant gains in controlling inflation although they should stand ready to take appropriate measures should imbalances emerge, as the Finnish experience had demonstrated.

Finally, Mr. Mtei commended the Finnish authorities for their commitment toward raising official development assistance despite their economic difficulties. That commitment was clearly shown by the announcement that ODA appropriations in 1984 would amount to the equivalent of 0.39 percent of GNP, an increase from 0.20 percent in 1979.

The staff representative from the European Department remarked that even if it could in some sense be said that Finland had followed a stop-and-go policy over the medium run, in the more immediate future he saw no particular danger of such a policy being pursued that could result in a sudden shock to the economy. The Finnish economy had an underlying strength that could be maintained even if additional restrictive measures became necessary during the course of the current year. The medium-term program for 1977-82 had indeed been successful in guiding policy in the past, as Mr. Lindå had also pointed out. While no formal medium-term program had been designed for the future, the authorities, in formulating their policies, were taking medium-term considerations into account as reflected in the two scenarios described on pages 7 and 8 of the staff report. Fiscal policies for 1984 were clearly in line with the "active" scenario, the objective being to decrease and not to increase the budget deficit; based on the budget proposals, public expenditure would decrease in real terms in 1984. The Government also intended to maintain the supply-side orientation of its policies. Although the burden on industry had perhaps been eased to some extent by the decrease in social security contributions, there was a limit to how far the authorities could go in that direction and, to his knowledge, they did not at present plan to take any further steps.

Obviously, there was some relationship between wage developments and unemployment, the staff representative continued, but it would be difficult to quantify it because of its diverse nature.

The Government had set a somewhat ambitious goal for wages in 1984, the staff representative considered, although it did not imply a fall in real wages. The aim to limit wage increases to 3 percent applied to negotiated wage agreements; the average increase in wage earnings of 8 percent would be equal to the targeted rate of inflation. As a matter of fact, inflation had been lower in 1983 than had been originally estimated, and the authorities hoped for a slightly better performance in 1984 than originally forecast. As for the present state of wage negotiations, the major trade union had requested a wage increase over three years of 9 percent. There had been some talk of a strike if the negotiations did not lead to an agreement. In the event wage developments were not close to the target, the authorities had expressed to the staff their firm intention of taking the necessary measures to achieve their inflation targets. The specific measures had not been outlined, but they would presumably call for both monetary and fiscal policies to play a role; certain indications were given in the staff report of areas for possible action.

The Government had no way of intervening directly in wage negotiations, the staff representative explained, although it could exercise moral suasion. The Government had recently appointed to the position of mediator the highly respected person who had played the same role during the 1981 wage talks. It was always difficult to judge whether or not a government should be a wage leader, but in Finland, the authorities saw no great benefit in doing so, even if it could.

Although in the past the practice of supplementary budgets had contributed to the more expansionary stance of fiscal policy, those budgets had been in line with the general policy stance in both 1982 and 1983, the staff representative explained. With hindsight, everyone realized, including the authorities, that the supplementary budgets might have resulted in too expansionary a policy. As regards 1984, the authorities recognized the need for fiscal restraint and intended to follow quite strictly their policy of fighting inflation; therefore, there was much less likelihood of such supplementary budgets being used, although it was always difficult to forecast fiscal developments with any precision.

The authorities also recognized the need to review the structure and level of interest rates, the staff representative noted. Opinion in Finland on interest rates had been changing. Traditionally, interest rates had been kept low in order to give an incentive to industrial investment, and also to make housing available on cheaper terms, in line with the basic philosophy of Finland and of other countries in northern Europe. But the authorities had recognized the importance of positive interest rates in real terms and of a structure of interest rates that was not unnecessarily complex. It might be of interest to note that the Governor of the Bank of Finland had stated, on the occasion of the closing of books for 1983, that it was essential for interest rates to reflect demand and supply in the financial market more accurately in the future than hitherto. The result would be higher real interest rates; the shift to freer interest rates would encounter considerable adjustment problems so that a gradual transition was necessary. The question in the minds of Executive Directors, and of the staff as well, was how gradual the transition should be. As he had noted, the authorities had an open mind and had tried to steer in the direction of freer interest rates.

Several steps had also been taken, again on a gradual basis, to try to bring the "gray" and the regulated financial markets together, the staff representative explained. At the beginning of 1984, commercial banks had been allowed to pass on to customers 60 percent instead of 50 percent of the cost to them of obtaining funds in the unregulated market where interest rates are higher. Initially, in May 1983, the figure had been set at 40 percent. Step by step, therefore, interest rates were being made a more effective tool in balancing the demand for and supply of credit.

The question of Finland's bilateral agreement with a large non-Fund member had also to be seen in a broad historical and geographical context, the staff representative from the European Department considered, and not necessarily only in narrow economic terms. It should be noted that the balances had accumulated relatively fast, once oil exports to Finland grew less than previously, while the demand for imports from Finland had remained high. There had already been a substantial reduction in those balances, and the idea was to reduce them over time in the framework of the bilateral trade agreements and the yearly protocols on trade.

An 18-month consultation cycle had been proposed for Article IV consultations with Finland, the staff representative explained, because of the far greater awareness by the authorities of the importance of tackling the problem of inflation. As he had mentioned, they were ready to take further steps if necessary to achieve their goals. Moreover, the wage demands that had been placed on the table at the beginning of the negotiations were not so high as to unleash highly excessive wage developments in the course of 1984. Furthermore, as mentioned earlier, the Finnish economy was quite strong, and the export sector was no longer so reliant on the wood industries; more and more, exports were manufactured goods of various kinds. Although the staff did not see any danger of a difficult situation arising in Finland in the immediate future, it was always wise to be on guard; the staff would continue to monitor developments and would certainly be ready to bring forward the Article IV consultation if developments in the areas mentioned by Mr. Wicks gave any cause for great concern.

The Deputy Director of the Exchange and Trade Relations Department explained that the proposed decision relating to the bilateral payments arrangement with Hungary was consistent with the Fund's normal practice of granting approval of a restriction, when it was justified, for a period of approximately one year. That was the procedure followed in January 1982 in concluding the previous Article IV consultation with Finland, when the bilateral agreement with the People's Republic of China had been approved until the end of January 1983. The agreement had in fact been terminated on January 1, 1983, before the expiry of the period. The proposal to approve Finland's agreement with Hungary until the end of January 1985 was also consistent with the plans of the Finnish authorities, who intended to take up the matter with the Hungarian authorities toward the end of 1984 with a view to terminating the agreement soon after the end of the year. The staff expected that it would be possible for the agreement to be terminated before the period of approval expired. If not, the staff would ascertain the reasons for the delay, and if the termination of the agreement appeared to be forthcoming within a short time, the Executive Board could certainly extend its approval accordingly.

Mr. Lindå observed that Executive Directors had been interested in developments in the Finnish monetary markets, especially in the so-called unregulated part, and in the arsenal of monetary tools. The Bank of Finland was at present pursuing a policy that allowed demand and supply conditions to play an increasing role in the unregulated market. As the staff representative had already indicated, the policy was aimed at incorporating the unregulated market into the system or, in other words, at adjusting the present system to better reflect market forces. However, after a long period of regulation, a rapid shift to free interest rates could not be achieved without considerable adjustment problems. To avoid various kinds of distortions, the Bank of Finland was continuing to strive for a gradual process of change in the financial markets. A reduction in inflation, which seemed to be under way, would however markedly alleviate those transitional problems. As for the monetary tool arsenal, his Finnish authorities were well aware of the need to diversify the transmission mechanism of monetary policy. The Bank of Finland was actively considering various methods, including those suggested by the staff, but it felt the need to proceed with caution in the present transitional phase. In reply to a specific question by Ms. Bush, he said that the central bank was not at present contemplating introducing definite monetary targets.

As several Directors had pointed out, Mr. Lindø continued, the ongoing wage negotiations, which were in a critical phase, were of crucial importance to the successful implementation of economic policy, especially to the official inflation target. The role of the Government in the discussions was limited, especially at a time when the Government's fiscal position did not allow for any significant handouts. Nor did the Government's wage negotiations with civil servants play a leading part in the overall wage negotiations. The Government's contribution to the negotiations had been limited to the appointment, effective February 29, 1984, of a special mediator who was trying to promote the negotiating process. The Government had also warned against inflationary wage settlements and had stated that budgetary measures would be taken should the wage increases exceed the target of 3 percent for 1984. The Governor of the Bank of Finland had also indicated that measures would be taken in such a situation. The latest news indicated that the difference between the employers' figures and the wage demands of employees was about 2.5 percent.

A question had been raised by Mr. Wicks regarding the external debt burden, should economic developments prove more unfavorable than anticipated, Mr. Lindø noted. He could not foresee a situation in the near future that would create financing problems for Finland. First, Finland had lowered its external indebtedness/GNP ratio from about 21 percent in 1977 to about 17 percent at the end of 1983. Second, the need for long-term external financing appeared to be markedly lower because the need for investment in infrastructure could be envisaged as diminishing. Third, Finland, known as a country that had fully paid its war debts, had traditionally enjoyed favorable treatment in the international financial markets, and continued to do so.

With respect to the surplus on Finland's trade account with the U.S.S.R., Mr. Lindø remarked, the purpose of the special deposit scheme had been to arrange, by mutual agreement, for temporary bridging in order to balance the bilateral account in the longer term. He felt that it was in the interest of the Finnish economy to try to reduce the imbalance, thereby increasing the possibilities for Finland to export to the U.S.S.R.

At times, Mr. Lindø commented, Finland might well have found itself having to resort to policies that might be characterized as "stop-and-go." As a small, very open economy, with exports that had been sensitive to cyclical movements in world trade, Finland's balance of payments had sometimes led to strong internal policy measures. However, with more diversified exports (and, hopefully, with less abrupt world trade fluctuations), Finland had been able to rely on smoother policy measures. Therefore, he would not call Finnish economic policies--at least not in the 1980s--"stop-and-go" policies. Policy measures in 1982 had been directed toward improving the worsening employment situation. The measures had included a devaluation in October 1982, combined with certain other measures directed to improving the competitiveness of Finnish industry. Due to unfortunate errors in the basic data, the policy might in retrospect have been somewhat too reflationary.

The Chairman made the following summing up:

Directors noted that economic developments in Finland had been generally favorable in the late 1970s and early 1980s. Economic growth had been high by international standards and Finland had been spared serious problems of external imbalance. However, Directors expressed concern about the expansionary stance of policy in recent years. In particular, the devaluations of the Finnish markka in October 1982 should have been accompanied, in the view of many Directors, by a more decisive tightening of policy, in order to avoid a renewed erosion of price competitiveness. Against this background Directors commended the authorities for the emphasis now being placed on the crucial objective of fighting inflation. They noted, however, that even if the 1984 price objective were to be met, inflation in Finland would remain somewhat high by current international standards.

Directors welcomed the tightening of fiscal policy envisaged under the 1984 budget. In view of the past practice of introducing supplementary budgets in the course of the budget year, they warned against permitting slippage to occur. Also, caution was advised with regard to the present and prospective level of foreign indebtedness.

Directors expressed concern about the apparent inability of monetary policy in 1982-83 to bring about a slowdown in the growth of the monetary aggregates and about the size of the "gray" market. They believed that this had to do with rigidities and imperfections in the financial system, which had impaired somewhat the effectiveness of monetary policy. Directors therefore welcomed the measures recently taken toward deregulating and streamlining the financial system. Directors urged the Finnish authorities to increase the flexibility of interest rate policy, to raise rates to positive levels in real terms, and to diversify the instruments at the disposal of the monetary authorities.

Directors observed that the results of the present round of wage negotiations would be crucial for the successful achievement of greater price stability and for safeguarding competitiveness. They believed that the authorities should be prepared to take further restrictive action if the outcome of the negotiations threatened those objectives. They also emphasized that the authorities should stand ready to further tighten fiscal and monetary policies should the need arise. Furthermore, Directors urged the Finnish authorities to devise their economic policies in a medium-term framework, using a judicious blend of structural policies and demand management actions.

Directors commended the authorities for their commitment to raise the level of official development assistance.

In view of the comments made by Executive Directors, it is recommended that the next Article IV consultation cycle with Finland be determined, within an outside limit of 18 months, in the light of economic and financial developments in the member country.

The Executive Board then took the following decision:

Exchange Measures Subject to Article VIII

1. The Fund takes this decision relating to Finland's exchange measures subject to Article VIII, Section 2(a), in light of the 1983 Article IV consultation with Finland conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund welcomes the termination of the bilateral payments arrangements with two Fund members and the intention of the authorities to terminate a bilateral payments arrangement with a third Fund member. The Fund grants approval until January 31, 1985 of the restriction on the making of transfers of balances for current international transactions arising from the remaining arrangement.

Decision No. 7640-(84/35), adopted
March 2, 1984

APPROVED: August 20, 1984

LEO VAN HOUTVEN
Secretary