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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/37

10:00 a.m., March 9, 1984

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

Executive Directors	Alternate Executive Directors
A. Alfidja	
	H. G. Schneider
B. de Maulde	X. Blandin
A. Donoso	
R. D. Erb	M. K. Bush
	T. Alhaimus
T. Hirao	T. Yamashita
J. E. Ismael	Jaafar A.
R. K. Joyce	L. Leonard
A. Kafka	
G. Laske	W. Moerke, Temporary
G. Lovato	C. P. Caranicas
	A. S. Jayawardena
	V. Govindarajan, Temporary
Y. A. Nimatallah	E. M. Ainley, Temporary
	T. de Vries
	K. G. Morrell
	O. Kabbaj
	E. I. M. Mtei
	J. L. Feito
J. Tvedt	A. Lindø
N. Wicks	J. Bulloch, Temporary
Zhang Z.	Wang E.

L. Van Houtven, Secretary
J. A. Kay, Assistant

Also Present

European Department: L. A. Whittome, Counsellor and Director; B. Rose, Deputy Director; O. J. Evans, M. T. Hadjimichael, S. M. Thakur. Exchange and Trade Relations Department: C. D. Finch, Director; W. A. Beveridge, Deputy Director; S. Mookerjee, Deputy Director, J. P. Lipsky. Fiscal Affairs Department: G. Blondal, R. J. Hurnard. IMF Institute: M. Montaniees, Participant. Legal Department: G. P. Nicoletopoulos, Director; A. O. Liuksila, S. A. Silard. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; J. Ferrán, A. M. Jul, T. M. Reichmann. Office in Europe: J. Forestier. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: H. A. Arias, C. J. Batliwalla, J. Delgadillo, S. El-Khouri, H.-S. Lee, G. E. L. Nguyen, Y. Okubo, M. Z. M. Qureshi, D. I. S. Shaw, D. C. Templeman. Assistants to Executive Directors: H. Alaoui-Abdallaoui, J. R. N. Almeida, I. Angeloni, Chen J., L. E. J. M. Coene, M. Eran, I. Fridriksson, D. Hammann, J. M. Jones, H. Kobayashi, M. J. Kooymans, G. W. K. Pickering, E. Portas, J. Reddy, A. A. Scholten, Shao Z., S. Sornyanyontr, Wang C. Y.

1. UNITED STATES - 1984 ARTICLE IV CONSULTATION - PRELIMINARY ARRANGEMENTS

The Chairman informed the Executive Directors that the staff was preparing for the mission to the United States in connection with the 1984 Article IV consultation. He had agreed with Mr. Erb that it might be useful if Executive Directors with an interest in the matter would indicate to the mission the sort of questions that they would like it to explore. Executive Directors interested in posing questions should be in touch with the Associate Director of the Western Hemisphere Department within the next ten days or so.

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

2. BRAZIL - EXTENDED ARRANGEMENT - MODIFICATION; AND EXCHANGE SYSTEM

The Executive Directors, considered in a restricted session, a paper on Brazil's request for a waiver and modification of performance criteria in connection with an extended arrangement for Brazil approved on February 28, 1983 in an amount equivalent to SDR 4.2 billion (EBS/84/39, 3/2/84).

The Executive Board took the following decisions:

Extended Arrangement - Modification

1. Brazil has consulted with the Fund in accordance with paragraph 4, last sentence, of the extended arrangement for Brazil (EBS/83/33, Sup. 4, 3/3/83, as amended) and paragraph 29 of the letter dated January 6, 1983 from the Minister of Finance and the President of the Central Bank of Brazil, in order to reach understandings with the Fund regarding the circumstances in which purchases by Brazil can be resumed under the arrangement.

2. The letter dated February 27, 1984 from the Minister of Planning, the Minister of Finance, and the President of the Central Bank shall be attached to the extended arrangement for Brazil; and (a) the letter dated January 6, 1983, together with the attached memorandum, from the Minister of Finance and the President of the Central Bank, (b) the letter dated February 24, 1983 from the Minister of Finance and the President of the Central Bank, (c) the memorandum dated March 31, 1983 from the Executive Director elected by Brazil, (d) the letter dated September 5, 1983 from the Minister of Planning and the Minister of Finance, (e) the letter dated September 15, 1983, together with the attached memorandum, from the Minister of Planning, the Minister of Finance and the President of the Central Bank, and (f) the letter dated November 14, 1983 from the Minister of Planning, the Minister of Finance, and the President of the Central Bank, shall be read as modified and supplemented by

the letter dated February 27, 1984 and by the quantitative performance criteria for the period ending March 31, 1984 as specified in Table 2 of EBS/84/39 (3/2/84).

3. (a) The performance clause in paragraph 4(a)(i) of the extended arrangement shall be amended to read:

> during any period in which the data at the end of the preceding period indicate that the target for the net international reserves of the Brazilian Monetary Authorities, as specified in paragraph 1 of the technical memorandum of understanding dated September 15, 1983, in paragraph 7, third sentence, of the letter dated November 14, 1983, and as modified in Table 2 of EBS/84/39 (3/2/84), is not observed, or"

(b) The performance clause in paragraph 4(a)(iv) shall be amended to read:

> during any period in which the limit on the net domestic assets of the Brazilian Monetary Authorities, as specified in paragraph 4 of the technical memorandum of understanding dated September 15, 1983, in paragraph 3, fifth sentence, of the letter dated November 14, 1983, and as modified in Table 2 of EBS/84/39), is not observed, or

(c) The performance clause in paragraph 4(a)(v) shall be amended to read:

> during any period in which the data at the end of the preceding period indicate that the limit on the use of external credit, as specified in paragraph 5 of the technical memorandum of understanding dated September 15, 1983, in paragraph 7, third sentence, of the letter dated November 14, 1983, and as modified in Table 2 of EBS/84/39 (3/2/84), is not observed, or

(d) The performance clause in paragraph 4(a)(vii) shall be amended to read:

> if the intentions to eliminate certain exchange restrictions, including those evidenced by payments arrears, and multiple currency practices that are specified (A) in paragraph 15, third sentence, of the letter dated September 15, 1983, (B) in paragraph 7(ii) (with respect to receipts from coffee exports only) of the technical memorandum of understanding dated September 15, 1983, and (C) in section 2, second paragraph, of the letter dated February 27, 1984, are not carried out before March 31, 1984, on January 2, 1985, or before March 31, 1984, respectively;

4. The Fund finds that no other understandings are necessary regarding the circumstances in which purchases may be made under the extended arrangement and that in these circumstances Brazil may proceed to request purchases under the arrangement.

Decision No. 7642-(84/37), adopted
March 9, 1984

Exchange System

1. The approval set out in Decision No. 7563-(83/160), adopted November 22, 1983 with respect to the exchange measures described under points (1) and (5) on page 25 in EBS/83/227, 10/19/83 is extended until March 31, 1984 or the conclusion of the 1983 Article IV consultation with Brazil, whichever is earlier. The approval with respect to the exchange measure described under point 3(e) on page 25 in EBS/83/227, 10/19/83, also will apply to the enlargement of the exchange tax to purchases of exchange for petroleum imports. Furthermore, the approval with respect to the exchange measure described under point 3(a) and pertaining to receipts from coffee exports on page 25 in EBS/83/227, 10/19/83, is extended until January 2, 1985.

2. Pending the completion of bilateral arrangements for the rescheduling or refinancing of Brazil's external debt pursuant to the recommendation adopted by the Paris Club on November 23, 1983, the Fund grants approval of the restriction on payments and transfers for current international transactions that are covered by that recommendation.

Decision No. 7643-(84/37), adopted
March 9, 1984

3. NEW ZEALAND - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with New Zealand (SM/84/40, 2/6/84; Cor. 1, 3/6/84; and Sup. 1, 3/6/84). They also had before them a report on recent economic developments in New Zealand (SM/84/46, 2/17/84; and Cor. 1, 3/6/84).

Mr. Morrell made the following statement:

I would like to express the gratitude of my New Zealand authorities to the staff for its constructive approach to the discussions recently held in Wellington, and for the comprehensive and discerning set of papers which it has prepared. The discussions were held in a frank and friendly atmosphere, and were mutually enlightening. The staff papers, with which my authorities are in substantive agreement, provide a fair summary of recent developments in the New Zealand economy.

New Zealand is a country well endowed with natural resources, for both agricultural production (good climate, soil and land formation) and energy generation (rivers for hydroelectricity, natural gas reserves, and coal reserves). Unfortunately it is situated in the world's less populated hemisphere and is a great distance from the major markets for its agricultural exports. In addition to the cost disadvantages resulting from its physical location, New Zealand has to contend with an elaborate array of protective mechanisms erected against its exports by, primarily, the major industrial countries.

While last year's staff report and paper on recent economic developments placed some emphasis on these difficulties of market access, the 1983 consultation report does not, in my view, give sufficient attention to this serious and continuing problem.

As last year's report noted, economic events in New Zealand have been dominated by the wage-price freeze that was initially imposed in June 1982 for a 12-month period and later extended until February 29, 1984. The freeze has been singularly successful in reducing the rate of recorded inflation, from 17 percent in the year ended June 1982 to 3.5 percent in the 12 months to December 1983, although it would be fair to say that inflationary expectations have not yet been completely eliminated.

The staff appraisal has identified public finances as the most notable area of disequilibrium and has pointed out (page 5) the conflicts between the fiscal position and the authorities' inflation and interest rate objectives.

My New Zealand authorities are aware of these difficulties and the Government is committed to the reduction of the fiscal deficit in the medium term. The current level of the deficit arose from the Government's actions to use tax cuts to help maintain the level of disposable incomes, and hence activity and employment, during the freeze and international recession while reducing real pretax wage rates (in terms of consumer prices). For associated reasons, increases in government charges and/or indirect taxes were ruled out. My authorities believe that any action taken to reduce significantly the expansion in the fiscal deficit would have risked exacerbating the 1982/83 recession.

The Government has acknowledged that the fiscal deficit is large and that, when economic conditions permit, some reduction in the structural component of the deficit must be made. My authorities do not disagree with the discussion in the staff report (page 5) on the nature of the deficit problem and agree that much of the adjustment will need to take place on the revenue side. Again it is very much a matter of timing. The most obvious adjustment--an increase in the indirect tax base--would lead directly to a rise in the level of consumer prices and would increase wage drift and union pressures for a higher wage round.

The ending of the price freeze will enable adjustments to be made to a number of government charges. As with private sector price increases, increases in government charges will vary considerably across activities. My authorities are assuming an average increase of about 5 percent during 1984/85.

As to monetary policy, the New Zealand Government has sought to avoid the prolonged period of high real interest rates which it has observed are associated with some disinflationary programs in other countries. The direct interventions in interest rates and associated decisions on its debt sales programs have been designed to bring about a rapid reduction in nominal interest rates, reflecting the reduction in the measured rate of inflation and the importance of interest in the cost structure of households and businesses.

While the more modest debt sales program that has been pursued since Kiwi Savings Stock I was terminated in June 1983 has permitted a rapid acceleration in money and credit aggregates, my authorities do not expect this to cause an early resurgence of consumer price inflation as long as increases in import and export prices and wage costs are relatively modest.

The 1 percent a month credit growth guideline is still in place although it has been consistently exceeded by some major institutional groups in recent months. The Government's response has been to increase finance company and building society ratios, and to reduce targeted trading bank free reserve margins (to minus $NZ 50 million for March). The authorities are currently reviewing the question of whether 1 percent a month credit growth is now too high in view of the current and expected levels of inflation.

Concerning wages, the authorities intend to ensure that only a moderate movement in wage rates will take place in 1984. The consumer price index forecast for the March quarter of 1984 implies a cumulative increase of only 7.5 percent since the September quarter of 1982 when the freeze became fully effective. Wage rates, as measured by both "nominal" and "prevailing" indices are expected to be essentially unchanged during the same period. (Real prevailing gross wages fell 7.5 percent between the March and September quarters of 1982.)

The tripartite talks continue to make gradual progress on medium-term wage fixing, with two matters in particular remaining unresolved--government monitoring of wage negotiations and the encouragement, if any, to be given to alternative wage-fixing structures. No agreement has been reached on the decentralization/centralization issues or the extent of the move from largely occupational bargaining (on which the present union structure is based) to an industry/plant level of negotiations. Discussions on short-term transitional options other than the freeze are not scheduled to be held until agreement has been reached on the medium-term issues. A further plenary session with ministers on medium-term issues scheduled for March 14 may lead to a resolution.

My authorities feel that an agreement on these major issues is still possible, which would allow a wage round later this year. If agreement cannot be reached, it is likely that some form of general adjustment will be given.

Economic activity in 1983/84 has been stronger than envisaged at the time of the consultations last December. My authorities believe that real GDP growth is likely to be about 1.5 percent in 1983/84, rather than the 1 percent discussed with the mission team.

Since the end of the June quarter of 1983, real retail and wholesale turnover has strengthened and real output in the manufacturing, building, and services sectors has increased. Manufacturing real output, seasonally adjusted (excluding the primary food sector) increased by 1.1 percent during the June quarter of 1983 and 5.5 percent during the September quarter of 1983--the latest available figure. There are indications that surplus capacity in manufacturing is now at its lowest level since the June quarter of 1982.

The growth in activity will apparently be sustained throughout 1984. At this stage my authorities expect real GDP growth of the order of 2 percent in 1984/85. Business confidence is increasing and there has been an increase in businessmen's intentions to undertake fixed investment over the next 12 months.

My authorities do not expect that there will be any dramatic increase in the annual inflation rate during 1984/85, and they are currently thinking in terms of an annual rate of about 6 percent.

The New Zealand Government has not yet taken a decision on whether or not to resume the crawling peg exchange rate regime which was suspended at the time of the imposition of the wage price freeze. During the year the exchange rate was moved in response to the devaluation of the Australian dollar, and was not subsequently adjusted as the Australian dollar strengthened again.

In conclusion, the New Zealand economy has made modest progress in the past 12 months as the authorities have taken the opportunity created by the freeze to try to establish longer-term solutions in the vital area of wage fixing. Inflation has been reduced markedly and there are no signs of a re-emergence of price pressures at this time. The Government has employed heavily interventionist measures in the monetary area in order to smooth the transition from a high- to a low-inflation economy. Overseas debt continues to be a concern, but the authorities are convinced that the situation is quite manageable.

I am looking forward to hearing my fellow Directors' views of developments in the New Zealand economy.

Mr. Hirao commented that in the past decade New Zealand's economy had been severely affected by a steep decline in the terms of trade, by the prolonged recession in the global economy, and by other external factors. Although economic activity had been buoyant in 1981/82, with domestic demand expanding by 6 percent, the rate of inflation had reached 17 percent in the middle of 1982. The authorities had responded to the difficult economic situation by imposing a freeze on prices, wages, and the effective exchange rate. He agreed with the staff regarding the freeze, although he wondered whether there had been any realistic alternative if a decisive halt in the existing inflationary psychology were to be brought about in the short run. The dramatic slowdown in the rate of inflation of 3.5 percent in 1983 was an impressive achievement, which he certainly welcomed. The present major issue was how to sustain the lower rate of inflation in the postfreeze period.

In the fiscal policy field, Mr. Hirao went on, many of the problems described by the staff seemed similar to those facing his authorities. Among them were an increase in debt service and social welfare payments, and the imbalance between direct and indirect taxation. The authorities' desire to cushion the effects of the recession and the freeze on disposable incomes and employment, and to avoid increases in indirect taxes or administered prices, was understandable, and their view that an increase in indirect taxes might be inconsistent with their anti-inflationary objective was not unreasonable. However, a structural budget deficit of more than 6 percent of GDP could only be viewed with concern. The staff had noted that the factors underlying the fiscal deficit were deeply entrenched, meaning that sustained and determined measures would have to be taken to reduce the deficit not only in the 1984/85 budget but in later years as well. In that respect, it was encouraging to learn that the authorities agreed that determined discretionary action sustained over a period of years was required to remove the threat to economic stabilization posed by the large fiscal deficit. He hoped that they would continue their utmost efforts to achieve that goal, despite social and political constraints such as the three-year election cycle.

He had also noted the authorities' view that many possible measures on the expenditure side, such as a review of entitlement policies and departmental economies, would not produce any marked immediate fiscal effects, Mr. Hirao observed. Although he understood that it was difficult to achieve any tangible results in the short term, the authorities would do well to view the matter in a longer-term perspective. He agreed with the staff that in the medium term, primary emphasis should be placed on the reduction of expenditure, while also giving priority to efforts to extend the tax base and to raise indirect tax revenue. An average increase of some 5 percent in government charges during 1984/85, mentioned by Mr. Morrell, should prove helpful in strengthening the revenue base.

As to monetary policy, Mr. Hirao remarked that the staff seemed to find a major problem in the authorities' attempt to maintain interest rates at an artificially low level. He had some sympathy with the authorities, who had argued that on grounds of equity interest rate controls were a necessary adjunct to the wage-price freeze, since interest was an important element of cost. However, on balance, he tended to concur with the staff that the restoration of an environment in which interest rates were freely determined was essential to the achievement of sound financial policies and tight monetary controls, both of which would be crucially important if the re-emergence of inflationary pressures was to be avoided after the end of the freeze. He had been glad to learn that the authorities were aware of the critical importance of containing monetary growth. Like the staff, he hoped that a quantitative guideline for monetary aggregates compatible with a sustained reduction in inflation could be established in 1984/85 and implemented with determination.

Commenting on New Zealand's wage-price policy, Mr. Hirao considered that the retention of a price surveillance system even after the end of the freeze would be appropriate. He would endorse the authorities' aim of allowing relative price changes to occur while keeping downward pressure on the general price level. He did however wonder how the objective could be achieved within a so-called notification system, under which firms were to be allowed no more than two price changes a year. Large companies were to file proposed price increases with the authorities, but small companies would not have to do so. He therefore wondered whether there was not a danger that small companies would decide on larger price increases than they would do otherwise. Some comment by the staff would be welcome.

In the wages field, Mr. Hirao considered that the agreement in principle to accept a round of constrained wage increases for 1984 would provide an appropriate basis for the wage negotiations for the postfreeze period. Although the new scheme had not yet come into effect, pending an agreement on a new form of medium-term wage determination, he hoped that the "officially stipulated" guideline, which was bound to be the key to the success of the scheme, would be written in a forward-looking manner. He would also endorse the authorities' objective of developing a wage fixing system that would allow a greater dispersion in wage settlements across industries, and that would weigh the ability of an industrial enterprise to pay more heavily than considerations of relativity. He had been encouraged to note from the staff report that there was seemingly a growing appreciation among the social partners that real wage restraints were essential to any adjustment process.

The staff considered that New Zealand's current account deficit in 1984/85 would remain equal to about 5 percent of GDP, Mr. Hirao recalled. At the same time, the external debt had amounted to 45 percent of GDP at the end of 1982/83. In those circumstances, he agreed with the staff that there was a need for a sustained effort to achieve a faster pace of external adjustment, and that a significant improvement in competitiveness was required. He endorsed the authorities' preference for improving competitiveness by moderating domestic cost increases. However, like the staff, he felt that competitiveness could not be improved solely by efforts to contain domestic costs; changes in the nominal exchange rate should not be ruled out.

Finally, Mr. Hirao stated, he welcomed the steps taken toward import liberalization. He hoped that further progress could be made toward a tariff-based system that would at the same time permit the authorities to dismantle a large number of export incentives, whose budgetary costs had grown significantly over the years.

Mr. Wicks stated that he endorsed the staff appraisal, which he found clear and incisive. It highlighted the main problems facing the New Zealand authorities: first, how to lift the price and wage freeze without a resurgence of inflation; second, how to reduce the fiscal deficit from an unsustainable level; and third, how to reach a sustainable balance of payments position in the medium term. He recognized that the fiscal and current account deficits were largely caused by past debt service commitments. They could not easily be reduced and there was therefore little room for other than unattractive policy options. The policy decisions facing the New Zealand authorities were not easy.

As the U.K. authorities well knew, it was exceptionally difficult to lift price and wage freezes successfully, Mr. Wicks went on. The New Zealand authorities had made an encouraging start, but he hoped that the partial lifting of the price and wage controls would be only the first step in removing the formidable battery of controls imposed on the economy. In 1983 controls had applied not only to prices and wages, but also to interest rates, the exchange rate, and imports. Taken together, they formed a major obstacle to the adjustment process, asd caused distortions and misallocations in the economy. Removing them in a coordinated and orderly fashion would be an essential element of any strategy for success in the medium term.

The freeze on prices and incomes had resulted in an impressive reduction in inflation and wage increases, Mr. Wicks noted. Particularly on the wage front, the New Zealand unions and the working people generally deserved considerable commendation. However, as inflation and nominal wage increases were currently lower than they had been for the past ten years, it was time to remove the controls. The gradualist approach taken by the authorities so far, and described in SM/84/40, Supplement 1, might be the only appropriate one at present; but he was glad that the authorities had acted to ease price controls before achieving agreement on a new incomes policy. He hoped that they would not be too gradualist in their approach to further liberalization. He was sure that the staff was correct in emphasizing the need to tighten monetary policy as the controls were lifted, so as to prevent a resurgence of inflation. The restrictions on interest rates were, however, a severe handicap to an effective monetary policy, as shown by the increasing difficulty experienced by the authorities in selling government debt, and by the recent increases in private sector credit expansion. The difficulties highlighted the need for a coordinated approach to removing controls.

As to wages policy, Mr. Wicks observed that it seemed essential to improve labor market flexibility. He therefore hoped that any new wage agreement would allow much more scope for wage increases to reflect underlying changes in productivity and would place less emphasis on wage relativity. The extent of the labor market rigidity was vividly demonstrated by the experience of 1981/82, when 80 percent of all wage settlements had fallen within 1/2 percent of a 10 percent increase.

Commenting on the fiscal policy of the New Zealand authorities, Mr. Wicks remarked that he considered the increase in the fiscal deficit of over 4 percent of GDP in 1983/84 to be excessive. At nearly 10 percent of GDP, the deficit was bound to be a burden on the New Zealand economy. While about one third was due to a 40 percent increase in debt service payments, the rest represented discretionary increases, connected particularly with social security and industry. Only a small proportion of the increase had been financed by means of taxation, the remainder falling about equally on monetary and nonmonetary financing. He was particularly disturbed to have read in Table 4 on page 18 of SM/84/40 that nearly 40 percent of net private savings in 1983/84 would go to finance the budget deficit. Altogether, the budget deficit amounted to some 70 percent of net private savings, an unsustainable level over the medium term. Priority must go both to reducing expenditure and to increasing revenue.

On the expenditure side, Mr. Wicks continued, the choices were quite unattractive. Nevertheless, he urged the authorities to explore urgently ways of reducing the burden of social security expenditure, a problem that was unhappily familiar to the U.K. authorities. He would also urge them to adopt a more radical approach to phasing out industrial assistance and to retrenching public investment policy. On the revenue side, he welcomed the authorities' acceptance in principle of the need to increase the emphasis on indirect taxation. It was worth noting that extending indirect taxes to cover all goods, except food and clothing, would cut the deficit almost in half. While such an action would certainly have a one-time only effect on inflation, it was worth considering.

He had two concerns in connection with New Zealand's external policy, Mr. Wicks observed: first, the level of the current account deficit and the persistent increase in external debt, and second, the debt service ratio projected for the remainder of the decade. The current account deficit derived entirely from the increasing deficit on invisibles and the transfer account. Table 25 on page 42 of SM/84/46 showed that the increase had been due largely to the reduction in investment income, and to a lesser extent to the reduction in income from "other services."

While the reduction in investment income was no doubt because of increased debt servicing costs, he would be interested to know from the staff the reason for the changes in the figures under the heading "Other services."

The debt service problem was expected to increase substantially over the decade, Mr. Wicks noted. The rise in the debt service ratio to 25 percent for official debt for 1989 was worrisome enough, but if private sector debt was included the figure reached some 40 percent. In particular, Table 7 of SM/84/40 showed that the debt service ratio (defined as total interest payments plus amortization payments on medium-term and long-term debt) on total debt was likely to amount to some 30 percent in 1986/87. Worse still, toward the end of the decade it was shown as rising to some 40 percent and there was no sign of a later decline.

Commenting on a reference to the viability of certain energy projects on page 10 of SM/84/40, Mr. Wicks observed that the staff had written that the New Zealand representatives agreed that the benefits from certain major projects should not be a cause for complacency regarding the urgency of external adjustment, especially since the medium-term economic viability of some of those projects was dependent on the long-term trend in the real price of oil. He would be interested to know what oil price assumptions had been used in connection with those rather substantial investments. He would also be interested to know who would bear the loss if the oil price increases did not take place as projected. Would the loss fall on the public sector or the private sector, or had the projects been so arranged that the loss would fall on the provider of the financing?

In sum, Mr. Wicks concluded, he urged the authorities to proceed very cautiously with their external debt policy. The persistence of a current account deficit of about 5 percent of GDP, despite the savings forecast on imported energy when the new projects came on stream, was a cause for concern. Tight credit controls to prevent excessive import expansion would be required. In addition, as the staff had stated, a significant improvement in competitiveness would be needed over the medium term. He fully endorsed the staff's emphasis on the need for a return to a flexible exchange rate system after the freeze as an important adjunct to the authorities' stress on moderating domestic cost increases.

Mr. Schneider said that he was in general agreement with the staff analysis and conclusions in the appraisal. In June 1982 the Government had imposed a comprehensive freeze on wages and prices for a protracted period in order to reduce inflation, but it had done little else to prepare the economy for the postfreeze period. Financial policies had become excessively loose, with a budget deficit reaching almost 10 percent of GDP in 1983/84. Moreover, despite the high deficit, interest rate policy had remained inflexible. As a consequence, major internal imbalances had developed that could easily rekindle inflation if policy measures were not speedily taken. He agreed with the staff that the New Zealand authorities should take the opportunity to develop an integrated economic strategy aimed at a gradual reduction of the fiscal deficit, including monetary restraint and measures designed to improve the competitiveness of the economy.

The most critical element in achieving balanced overall economic performance was fiscal policy, Mr. Schneider considered. The staff had rightly suggested that the emphasis should be placed both on cutting expenditure and on extending the tax base. In addition, more attention should be paid to raising indirect taxes, which represented only 25 percent of total fiscal revenue. Higher indirect taxes would have a positive impact on the restraint of consumption and the stimulation of savings. The ratio of tax revenue to GDP had been no more than 34 percent in 1982/83, while it had been some 36 percent in 1979/80. There was certainly room for raising indirect taxes, particularly in comparison with the ratio of tax revenue to GDP in a number of the smaller industrial countries in Europe.

On the external side, Mr. Schneider remarked that he was concerned by the persistent current account deficit of about 5 percent of GDP, the rapid buildup of external indebtedness, and the complex system of protection. It would be appropriate to control domestic costs to improve competitiveness, but the New Zealand authorities should also pursue a more flexible exchange rate policy in order to reverse the rapid increase in external debt, thereby arresting the steady increase in the debt service ratio, which was already high. Moreover, the adoption of a flexible exchange rate policy would enable the authorities to dismantle the protective structure, as well as the export incentives, over time. He had of course noted that New Zealand had to contend with an elaborate array of protective mechanisms erected against its exports, primarily by the major industrial countries.

In conclusion, Mr. Schneider considered that it was urgent for the New Zealand authorities to adopt and implement in a determined manner a global financial strategy that would help them to eliminate the external and internal imbalances over the medium term.

Mr. Joyce remarked that the price and wage inflation had declined sharply in 1983 and that international reserves had remained at comfortable levels. However, most other recent economic developments had been generally unfavorable, perhaps as a result of the external circumstances facing New Zealand. However, real output had declined in 1982/83, unemployment had continued to increase, and the fiscal and external imbalances had widened. The economic situation was therefore worrying. Medium-term real growth would not be more than about 2 percent a year, starting in 1985/86, and then only on the basis of fairly optimistic assumptions about policy developments in New Zealand and the state of the world economy.

The major policy weakness, Mr. Joyce went on, was that the authorities had actively pursued a freeze on wages, prices, and interest rates, without adopting sound fiscal, monetary, or external policies. The freeze had worked in part because there had been little growth in either the New Zealand economy or that of the world as a whole. Unfortunately, the freeze had not been short term but had been extended by almost a year from the original termination date. The staff had reported that the wage freeze had again been extended, while controls on interest rates on loans had remained unaltered. The authorities and the social partners should quickly come to an understanding not only on wages but also on ways to bring about greater labor mobility. The sooner the authorities lifted controls on interest rates, the sooner they would be able to make effective use of monetary policy.

As the staff had noted, virtually all the options open to the New Zealand authorities were unattractive, Mr. Joyce observed. Fiscal discipline would have to be restored, monetary policy made more restrictive, and the external sector made more coherent. The authorities should pay particular attention to broadening the revenue base, controlling expenditure on welfare and industrial assistance, containing the growth of the monetary aggregates, and resuming a flexible exchange rate policy. Further delay in addressing those issues would only lead to the need for greater adjustment and to further erosion of economic activity.

The authorities also needed a comprehensive strategy for shifting resources to the external sector, Mr. Joyce stated. Developments in cost competitiveness over the past few years had not been comforting, although there had been some encouraging signs, particularly in manufacturing, which ought to play a larger role in New Zealand's exports. The share of manufacturing in total exports had risen from 4.5 percent in 1970 to almost 20 percent in 1983, presumably reflecting, at least in part, the new trading arrangements with Australia. Capital investment had remained quite buoyant. A system of import quotas and export subsidies had probably helped to encourage growth in that sector, but manufacturers and other exporters could not continue to depend on subsidies and high cost inputs if they wished to become truly competitive.

Nevertheless, the agricultural sector would probably continue to be the main export earner in New Zealand for some time to come, Mr. Joyce remarked. Growth prospects for exports were clouded by the reduction of access to traditional markets, particularly in Europe; continued excess world supply; and, as the staff had indicated, relatively weaker commodity prices, particularly for dairy products. The authorities had however compounded the problem. High levels of protection offered to the nonfarm sector in New Zealand had spilled over and resulted in higher domestic farm costs, creating in turn a further squeeze on profits and farm incomes. He was glad to note that the New Zealand authorities planned to take further steps to liberalize the import system.

The figures in Table 2 on page 6 of SM/84/40, showing the relation of budget deficits and interest payments in selected industrial countries, ought to be interpreted with some care, Mr. Joyce said. For instance, in Ireland--one of the countries listed--the authorities had pointed out that some 40 percent of the deficit arose from investment expenditures, which could normally be expected to generate income with which to service the related borrowing. He would be surprised if the proportion were the same in other countries shown in the table, but perhaps other qualifications applied. Nevertheless, the table did clearly show the extent to which debt service caused by deficits pre-empted government revenues and restricted the room for fiscal maneuver, especially at a time of recession, when the return even on good investment expenditures could be poor.

The staff had reported that New Zealand's official development assistance was significantly higher in 1982/83 than it had been a year earlier, although it still remained a rather modest proportion of GNP, Mr. Joyce commented. However, the authorities were to be congratulated for their efforts, particularly at the present time, and he hoped that they would continue to provide tangible evidence of their commitment to assist developing countries.

There was ample evidence in the staff report that the New Zealand representatives basically agreed with the Fund on the nature of the problems facing the New Zealand economy and on the steps that needed to be taken, Mr. Joyce observed. However, time and again, the authorities seemed to feel that the prescriptions offered by the Fund would not be suitable at present. Judgments about such measures must of course always be made by the authorities themselves, but he could not help wondering whether the cost to New Zealand of waiting too long might not be greater than the authorities anticipated.

Mr. Ainley said that he could generally endorse the staff appraisal. It was clear that the New Zealand economy continued to face difficult problems. Although the wage-price freeze had been singularly successful in reducing the rate of inflation, performance in other areas had been disappointing. The immediate prospects were not encouraging, and the authorities would have to make difficult choices. Like others, he hoped that they would give more weight to medium-term, rather than short-term, considerations, and he hoped that they would not move too gradually. His impression was that the authorities were pushing problems into the future; in so doing, they might only make them worse.

So far, Mr. Ainley went on, the authorities had relied heavily on the wage-price freeze and other related controls. Unfortunately, they had not supported them by firm demand management policies. On the contrary, the controls seemed to have undermined the effectiveness of other policies. As a result, the fiscal deficit had increased considerably and monetary growth had accelerated. Neither the growth in the deficit nor the increase in the volume of money was consistent with the authorities' objectives. He therefore agreed with the staff that there was a need for a coordinated, longer-term strategy.

One important element in that strategy would be a more durable incomes policy to replace the wage-price freeze that would expire in August, Mr. Ainley observed. While it was difficult to introduce such a policy, he would encourage the authorities in their determination to resist "catching up" wage settlements. More generally, he would support the moves to reduce rigidities in the labor market and, in particular, to link wage awards more closely to productivity. Such moves could lead to new employment opportunities over the medium term. Naturally, an incomes policy would not, by itself, be sufficient to stabilize the economy. The authorities would need to strengthen the public finances and to reduce the budget deficit. Their concern about the short-term effects of fiscal restraint on output and employment was understandable; but the alternative of continued large deficits could lead to crowding out of private investment, or to excessive monetary financing and new inflationary pressures. They in turn would weaken the prospects for output and employment in both the short and medium term. He therefore hoped that the authorities would act to control expenditure and raise new revenue along the lines suggested by the staff. The introduction of a sales tax, proposed by the recent New Zealand Government Task Force on Tax Reform, would be one way of broadening the revenue base and reducing the deficit substantially.

On the monetary side, Mr. Ainley remarked that the rapid growth in the main aggregates of recent months was clearly incompatible with the aim of keeping inflation under control. He therefore supported the staff's call for a firmer monetary stance based on clear quantitative guidelines. He also agreed that monetary policy could operate more effectively if the authorities moved away from, instead of extending, ad hoc controls, which were now hampering sales of government debt.

In the external sector, the large current account deficit could not be sustained without further borrowing, Mr. Ainley considered, thus adding to the already high debt service burden and increasing the cost of adjustment in the medium term. More decisive action was required to improve competitiveness and to transfer resources to the external sector. A combination of firm financial policies with a more flexible stance on the exchange rate could help to reduce the deficit to more manageable levels; and the experience of the period 1974-79 showed that such a combination of policies could be effective in promoting external adjustment for New Zealand.

Finally, Mr. Ainley remarked, the staff had made a strong case for dismantling the present complex and costly set of export incentives and import restrictions. It was true that such an endeavor would take a considerable time, especially as New Zealand's major exports faced an elaborate array of protective mechanisms elsewhere. The authorities had made a useful start by moving to open up their import licensing procedures, and he hoped that the process of trade liberalization would continue, both in New Zealand and in its main trading partners.

Mr. de Vries commented that while New Zealand had been singularly successful with its income policy, it had simultaneously adopted loose fiscal and monetary policies. Whether or not the wage agreements could be renewed, sooner or later the expansionary effects of such loose policies would assert themselves. He certainly hoped that it would be possible for the social partners in New Zealand to renew their successful incomes policy in the future, thus giving the authorities some time to put the other aspects of their economic policy in order.

The budget deficit was not only quite large at 10 percent of GDP, it had been increasing rather rapidly in the past year, Mr. de Vries remarked. Like Mr. Wicks, he had noted that the staff had enumerated all the forces that had led to an increase in government expenditures; such an enumeration made it all the more evident that it was essential for the authorities to tackle the problem, which would only become worse the longer it was allowed to persist. Apart from the familiar problems of rising social security payments, there was the difficulty in New Zealand, as in many Western European countries, of a large degree of subsidization of all sorts of activities, requiring the Government to levy increasingly heavy taxes. While it could be argued that without subsidies activities would not take place because the public was short of funds, once both taxes and subsidies were reduced, it would be seen that there was plenty of scope for activity in the private sector that would not have been possible at the higher tax rates. While there were many differences between New Zealand and Denmark, there were some parallels. The Danish authorities had found it possible to finance a fiscal deficit by borrowing abroad for a considerable time, but after some years the necessary adjustments had turned out to be rather large. He had been very much struck by Mr. Joyce's point, which he recognized from the Netherlands, that while there was agreement on the difficulties to be overcome, there was considerable hesitation to start taking the necessary action. In the Netherlands, it had been found that the longer the delay in starting, the more difficult the adjustment became. He therefore hoped that the New Zealand authorities would begin to take action rather rapidly.

Mr. Ismael commented that in the past few years the New Zealand economy had been characterized by severe domestic and external imbalances. Domestic imbalances had arisen primarily from expansionary fiscal and monetary policies, excessive wage increases, and a highly protected domestic industry. The result had been major inefficiencies and strong inflationary pressures. In the external sector, the main sources of difficulty had arisen from the prolonged world economic recession, the decline in the terms of trade, economic restrictions in foreign markets, and the increase in the price of oil, to which the country had failed to adjust. In the circumstances, he would like to make suggestions on the direction in which the authorities might turn for the future.

One important objective for the authorities, Mr. Ismael went on, should be to bring inflation under control. The freeze that had been imposed on prices and incomes had resulted in a decline in the inflation rate from 17 percent in the middle of 1982 to less than 4 percent at the end of 1983. Nevertheless, he wondered whether the low rate of inflation could be sustained in the future. There were reasons to believe that, once the freeze on prices and wages was removed, the rate of inflation would rise substantially. The main reason was that the stance of fiscal and monetary policies pursued by the authorities in 1983 in no way complemented the wage-price policy. In fact, they had moved in the opposite direction. For any wage-price policy to be effective, it would have to be supported by tight fiscal and monetary policies. In the circumstances of New Zealand, he would not be surprised if the inflation rate once again returned to 10 percent or more.

Monetary policy had continued to be very expansionary despite the leakage of liquidity through the balance of payments, Mr. Ismael noted. In November 1983 the rate of M-3 growth had been 13 percent, a highly expansionary figure seeing that the inflation rate had been some 3.5 percent and there had been a decline in real GDP of about 1 percent. He urged the authorities to make more active use of interest rate policy as a means of reducing the growth of credit, and to engage in open market operations to remove excess liquidity from the system.

The stance and direction of fiscal policy were also a matter for great concern, Mr. Ismael went on. The fiscal deficit had been 5.5 percent of GDP in 1982/83 and it was expected to rise to 9.75 percent in 1983/84. He agreed with the staff that much of that deficit was structural in nature and that measures would have to be taken to reduce expenditure in the medium term, as well as to widen the tax base. As in many other countries that practiced welfare policies, the task of reducing government expenditure in New Zealand would prove to be difficult. A determined effort involving politically unpopular measures would be necessary to bring government expenditures under control.

The external sector had been weakened considerably as the result of the prolonged world economic recession, the decline in the terms of trade, restrictions on New Zealand's exports, and the increase in oil prices, Mr. Ismael considered. Unfortunately, financial policies in New Zealand had been too accommodating and had failed to adjust to such adverse external developments. The external current account deficit had increased to 6.5 percent of GDP in 1982/83, and the debt service ratio had risen to some 30 percent. Such figures raised questions about the sustainability of the current account deficit, and measures should be taken to promote exports. It would be particularly important to revert to the system of flexible exchange rates after the freeze on incomes had been lifted. He would appreciate it if the staff could explain why the New Zealand authorities had decided to devalue the currency by only 6 percent when its major trading partner, Australia, had devalued by 10 percent in 1983.

As to wage-price policies, Mr. Ismael noted that the price freeze was to be followed by some form of price surveillance system together with voluntary wage guidelines. He agreed with the staff that it seemed unlikely that such arrangements would keep inflation down if the macroeconomic policies remained expansionary. He also agreed with the staff comments on trade policies. He saw an urgent need for a major liberalization of the extensive system of protection based on import quotas, which should be replaced by tariff-based protection. He would also urge the authorities to reduce tariffs in the medium term so as to reduce distortions in the allocation of resources and to improve the efficiency of domestic industries through increased competition from imported goods.

During the coming year, Mr. Ismael remarked, it was expected that New Zealand's GDP would increase by 1 percent, and that some improvement would take place in the external accounts. More recently, the Reserve Bank of New Zealand had forecast real growth of 2 percent for the coming year. Nevertheless, he believed that the projected 5.5 percent rate of inflation for 1983/84 was rather optimistic. The forecast was based on a number of assumptions, all of which were unlikely to prove correct. The sluggishness in private investment together with the rise in unemployment to over 6 percent was a matter of concern; he did not believe that the unemployment rate could be reduced in the short run as both monetary and fiscal policies had reached the limit of their effectiveness.

The medium-term prospects for New Zealand, like those for other primary producing countries, seemed uncertain, Mr. Ismael observed. Much would depend on the strength of the economic recovery in the industrial countries, and the willingness of those countries to allow market access to primary products from abroad. Meanwhile, in the absence of a more favorable trading environment, New Zealand would have to adopt more cautious domestic policies and revert to a system of flexible exchange rates that had served it well in the past.

Mr. Moerke stated that he was in broad agreement with the staff appraisal. Since mid-1982 the cornerstone of the New Zealand Government's strategy had been a comprehensive freeze on prices, wages, interest rates, and the exchange rate. The freeze had contributed to the deceleration of inflation, and cyclical developments had contributed to the freeze's success. However, three questions might be asked: To what extent had the freeze reduced recorded inflation without eliminating the basic causes? Had the freeze been accompanied by appropriate financial policies? And, what should be the postfreeze adjustment strategy?

As to eliminating the causes of inflation, Mr. Moerke continued, there was one lesson that could be drawn from the experience of other countries that had relied on a price and wage freeze: it was essential for such a freeze to be supported by appropriately tight monetary and fiscal policies. The staff seemed to have shown that during the freeze the financial policies of New Zealand had not been very supportive. The budget deficit had increased substantially, while monetary expansion had been considerably higher than desirable. In the event, a rapid acceleration of money and credit had been accompanied by a substantial reduction in the recorded rate of inflation. A resurgence of inflation could not be ruled out after the termination of the freeze, unless fiscal and monetary policies were amended. While the authorities fully recognized the difficulties facing them in the period after the removal of the freeze, they did not seem to have developed a coherent and comprehensive postfreeze adjustment policy.

Taking up New Zealand's fiscal policy, Mr. Moerke said that he agreed with the observations made by Mr. Wicks, Mr. Schneider, and Mr. de Vries. One thing was particularly clear--the need to reduce the budget deficit. The staff had gone so far as to say that New Zealand was approaching the predicament of some other industrial countries, in which large cuts would have to be made in discretionary components of spending each year merely to prevent total spending from rising. Substantial adjustment could and should be achieved by extending the tax base, and by increasing indirect taxes. A tightening of fiscal policy would also help to contain inflationary expectations and assist in the necessary tightening of monetary policy.

New Zealand had been quite innovative in the field of debt management, Mr. Moerke observed; the authorities had introduced a new debt instrument and a tendering system that had undoubtedly improved the control of monetary conditions. The question remained, however, whether those measures would be sufficient to enable the authorities to finance potential budget deficits in a noninflationary manner. The tender of November 1983 had demonstrated that sales of government securities could be very limited when interest rates were kept artificially low. The fact that the following tender only a month later at the same interest rate had been much more successful seemed to need some explanation, especially as the latest tender, in February 1984, had again been less successful than had been expected. On balance, the removal of interest rate controls would further enhance the effectiveness of monetary policy. The authorities seemed to have discretionary measures at their disposal for making nonbinding guidelines more binding by penalizing financial institutions that did not adhere to them. Whether they would in fact find such a system to be an effective way of controlling monetary and credit expansion seemed to be rather doubtful. He would be grateful if Mr. Morrell or the staff would comment on the point.

Regarding price policies, Mr. Moerke said that he had noticed in SM/84/40 an indication that a price surveillance system would remain in place, and that two price changes a year would be allowed. The aim was to allow relative price changes to occur while exerting downward pressure on prices as a whole. Two questions ought to be raised: Which prices would be adjustable, and for what reasons? And, how effective was the price surveillance system likely to be?

As to wage policies, the resumption of the tripartite discussions on short- and long-term wage policy was welcome, Mr. Moerke remarked. It was also encouraging that some kind of consensus seemed to be developing among the social partners to the effect that real wage restraint was essential if the adjustment process was to succeed. The actual outcome of a "constrained" wage round for 1984 was, however, still uncertain. Despite the reduction in real wages during the freeze, the economy appeared to be insufficiently competitive, as shown by the existence of an extensive network of import protection and export incentives. If the New Zealand economy was to become internationally competitive, there might need to be a further adjustment of real wages.

On the external side, a major problem in the medium term would be the current account deficit, Mr. Moerke commented. To some extent, the deficit might have reflected the effect of the world recession in recent times, so that the projected recovery ought to help reduce the deficit in the short term. Nevertheless, the unsatisfactory external performance of the economy over recent years also reflected a deterioration in New Zealand's export competitiveness. Without further adjustment, a large deficit seemed likely to remain. The need for a reduction of the deficit was a matter of some urgency, since external debt servicing had become a large part of total earnings.

In principle, Mr. Moerke stated, he had some sympathy for the authorities' view that competitiveness could be improved mainly through a moderation in domestic cost increases. However, considering the size of the necessary external adjustment, and the uncertainty regarding the stance of financial and wage policy, a more flexible exchange rate policy should not be ruled out. The reintroduction of the crawling peg exchange rate regime would be quite appropriate in the present circumstances. Successful longer-term developments required a more competitive environment involving a level of exchange rates that allowed for dismantling export subsidies and import restrictions.

Mr. Tvedt commented that the staff papers for the 1983 Article IV consultation with New Zealand described some policies that had been quite successful, while others had been inconsistent with the long-term viability of the economy.

The freeze introduced in January 1982 had clearly resulted in a sharp deceleration of wage and price increases, Mr. Tvedt noted. He would have expected the objectives of such a program to be not only to reduce inflation but perhaps to break inflationary expectations. However, he had gained the impression from the staff that the progress in changing expectations had been less than the authorities had anticipated. The introduction of fully indexed government bonds in the middle of the second year of the freeze did not seem to indicate that the authorities were very confident that they would be able to contain inflation in the future.

In certain circumstances a price freeze could be an effective short-term tool in battling inflationary tendencies, Mr. Tvedt considered. At the same time, inflationary tendencies only arose if there had been a lack of effective macroeconomic policies or of flexibility in economic management. A rigid price freeze should never be maintained over an extended period because of its detrimental effects on the efficiency of the economy. The New Zealand authorities seemed to be relying excessively on the freeze, which had been in effect for nearly two years with only a partial lifting at the end of February 1984. New Zealand had traditionally had a rather protected economy, in which the price mechanism had hardly been given a decisive role in the allocation of resources. Such a traditional setting, together with the comprehensive freeze of the past two years, must be considered largely responsible for the sluggish growth in the economy, the large budget deficit, and the unsustainable current account situation, which had led to the external debt representing some 45 percent of GDP. In addition, unemployment was high and various rigidities seemed to have been making it increasingly more difficult to terminate the price freeze. In that sense, the problems might become self-perpetuating.

The fiscal deficit was clearly becoming a major problem, Mr. Tvedt observed. The growing structural element was of particular concern. He agreed with the staff regarding the measures that should be taken to combat the deficit, and he underlined the inconsistency between the fiscal position and the authorities' inflation objectives.

On the external side, Mr. Tvedt remarked, the New Zealand authorities had been running unsustainable current account deficits, and were consequently engaged in substantial foreign borrowing. There was therefore clearly a need for a fresh approach to economic management. The fact that the tripartite negotiations had not yet led to any tangible results indicated to him that there might be a lack of confidence in the overall policy approach of the authorities, or that they had a less than well defined economic program. In the postfreeze period the authorities would have to accept various adjustments and corrections of the most notable distortions; the faster they moved toward liberalization the better.

His comments might seem rather critical, Mr. Tvedt remarked. Some criticism was due because the authorities' policies did not seem to him to be adequately conducive to balanced growth. He recognized many of the problems facing New Zealand, which were similar to those confronting the countries in his constituency. New Zealand was a country well endowed with human and natural resources that had to some extent suffered from restrictive practices in other countries. He had no doubt that the authorities would in time establish a more balanced policy approach; he hoped that they would become better able to exploit the competitive advantage of their traditional export industries.

Ms. Bush remarked that the New Zealand authorities had succeeded in sharply reducing the rate of inflation since the imposition of wage, price, and interest rate controls in June 1982. However, wage and price controls tended to create two problems: they might merely suppress inflationary pressures which would break out anew when the controls were lifted; or they might result in distortions in relative wages and prices, making the economy less efficient and less responsive to economic change.

The outcome of the experiment with controls was being seriously tested, Ms. Bush considered. The decision to continue with a price surveillance scheme, with interim wage controls and with a temporary extension of controls on lending rates, was evidence of a continuing problem. She would be interested in hearing what policies were likely to be adopted when the interim arrangements came to an end. Whatever final decisions were made, the policy environment at the time of the removal of controls should be such as to avoid a sudden resurgence of inflation, and relative wages and prices should be permitted to reallocate resources into the most efficient productive uses. The temporary imposition of controls had offered the authorities the opportunity of strengthening their anti-inflationary policies. Unfortunately, the present stance of both fiscal and monetary policy had not created a very favorable environment for the termination of controls.

The estimated increase in the ratio of the budget deficit to GDP from 5.6 percent in 1982/83 to about 9.8 percent in 1983/84, and the prospect of a ratio of 9-10 percent again in 1984/85, threatened to feed a resurgence of inflation, Ms. Bush declared. The problem seemed to be basically structural, on both the revenue and the expenditure sides. The cut in personal income taxes in October 1982 should have favored the growth of private savings and investment. However, the inelasticity of the revenue system--and particularly the very small base for indirect taxes--was a recognized constraint in reducing the deficit. As to expenditure, she perceived a familiar pattern of growing interest payments on the public debt, rising social welfare and social insurance transfers, and costly subsidies on interest rates and on public sector pricing. The authorities had taken some steps to facilitate financing the deficit in a noninflationary way by increasing the variety and attractiveness of government securities, thus helping to improve the future management of public debt. While it was better to finance the deficit through security issues to the nonmonetary sector rather than monetary expansion, the adoption of such new methods of financing the deficit should not weaken the efforts to reduce it. Deficit financing maintained at high levels could crowd out private sector borrowing.

On the monetary side, Ms. Bush continued, the acceleration in monetary expansion in late 1983 and early 1984 was disturbing. The desire to maintain low nominal interest rates conflicted with the need to finance large budget deficits, and the maintenance of such low rates might well jeopardize the mobilization of private savings and international capital flows. Real interest rates, insofar as they applied to government bond yields, had been distinctly negative from 1979 to 1982. However, the reduction in inflation during 1983 had resulted in substantially positive yields and deposit rates, thus making savings more attractive. More recently, the upward pressure on interest rates due to growing private credit demand and the weakness of household demand for government securities had threatened to undermine the low interest rate policy. She would be interested to know what the authorities intended to do regarding the control of interest rates after the extended surveillance expired in August 1984.

The termination of wage controls gave the authorities a chance to change the previous methods of determining wages, Ms. Bush considered. In the past, a few national wage contracts had set the pattern for the rest of the economy, a procedure that carried the danger both of excessive wage increases across the board and of a structure with too little wage differentiation. The latter could seriously impede the shifting of resources into new industries and the diversification of the export base. It was to be hoped that those considerations would be kept in mind during the continuing tripartite negotiations.

The main features of the New Zealand balance of payments, Ms. Bush observed, were the persistently large ratio of the current account deficit to GDP; the corresponding growth of the debt burden; and the extensiveness of trade restrictions. In part, the current account deficit reflected exogenous factors, such as adverse terms of trade and protectionism in New Zealand's agricultural export markets. However, the growing interest payments were also an important factor. An expansion of nonagricultural exports and success in import substitution for energy were both likely to be significant if New Zealand was to be able to service its debt. A return to a policy of exchange rate flexibility would certainly be helpful. The ratio of total foreign debt to GDP was already about 45 percent, and it was expected to rise to over 50 percent by the end of the decade. Similarly, the debt service ratio, currently about 20 percent, would rise to over 40 percent by 1987/88. Such ratios might well cause concern about the country's creditworthiness. In fact, she understood that New Zealand's credit rating had already been somewhat toned down by one of the U.S. private credit rating services. Naturally, the quality of economic policies and performance would be an even more important factor than debt ratios in shaping the views of foreign creditors.

Finally, the ultimate objectives of economic policy management ought to be an adequate rate of economic growth, the creation of employment, and a sustainable foreign balance, Ms. Bush stated. There was room for improvement in each of those areas in New Zealand. Real growth had averaged less than 1 percent during the five-year period 1979/80-1983/84. Job creation had been slow and unemployment was rising steadily, partly because of the turnaround in migration. It would be interesting to hear an assessment of the prospects for migration from New Zealand in the next few years. The external imbalance was still large and the debt service growing, despite the fact that New Zealand maintained export subsidies and significant restrictions on imports. She sympathized with the authorities' complaint about protectionist measures elsewhere that limited the growth of exports from an efficient agricultural sector. However, the argument against such protectionism would be stronger if New Zealand were not also making use of such devices. She urged the New Zealand authorities to dismantle them as soon as possible.

Mr. Mtei remarked that the New Zealand authorities had been quite successful in reducing the rate of inflation, which had been far out of line with the level in New Zealand's main trading partners. The evolution of other economic indicators had not been so encouraging, a reminder that the economy was still in difficulties. The growth of real GDP had been sluggish during 1983, with little change expected during 1984. The fiscal deficit was estimated to remain large, and the current account of the balance of payments was expected to deteriorate.

The economic difficulties facing New Zealand partly reflected the impact of the world recession, aggravated by an intensification of trade restrictions on the country's exports, which were mainly primary products, Mr. Mtei noted. The staff had suggested in SM/84/46 that there had been some increase in the output available for export; but export earnings had not shown a commensurate increase due to downward pressures on prices in world markets. Although a developed country, the problems that New Zealand faced as an exporter of a few primary commodities subject to large swings in prices were reminiscent of the plight of many primary producing developing countries whose external payments problems had been intensified by falling prices in world markets. He therefore welcomed the New Zealand authorities' efforts to diversify the composition of their exports, as well as their export markets.

As to the authorities' fiscal policies, Mr. Mtei considered that there was a dilemma between providing stimulus to support aggregate demand in the face of continuing weakness in economic activity, and containing the budget deficit, which threatened to annul the gains made on the inflation front. In those circumstances it could be argued, perhaps with hindsight, that the present problems would be less severe if the authorities had not reduced taxation at a time when expenditures on social services and projects deemed essential to the process of economic diversification had been on the rise. For instance, in 1983/84 spending had been estimated to increase by about 13 percent and revenue by only 2.4 percent, reflecting in large part the virtual stagnation of income tax revenue as a result of the income tax reductions, clearly demonstrated in Tables 30 and 31 of SM/84/46. In the circumstances, the authorities ought to seek to improve the revenue situation, perhaps by widening the tax base, since certain categories of expenditure could not be altered in the short run. He welcomed the authorities' recognition that much of the adjustment would have to be on the revenue side; he hoped that they would act shortly.

The staff had asserted in its appraisal that significant improvement in New Zealand's external competitiveness would be required to improve the adjustment process, and it went so far as to suggest that a change in the exchange rate might be needed, Mr. Mtei continued. He did not find any facts either in SM/84/40 or in SM/84/46 to support that conclusion. Despite the distance between it and its major markets, New Zealand was already an efficient producer of its principal export commodities--dairy and meat products--compared with many OECD countries which paid large farm support prices that were at least twice as high as the producer price in New Zealand. In addition, movements in the index of relative unit labor costs in the manufacturing sector in New Zealand did not provide a reliable guide for the overall competitiveness of the trading goods sector, since only a small proportion of manufactured commodities were exported.

As for the exchange rate of the New Zealand dollar, Mr. Mtei observed that there had been no appreciation in the real effective rate and that it was in fact slightly lower in 1983 than it had been before March 1982. The problem facing the export sector in New Zealand seemed therefore to be more one of growing trade restrictions in the country's principal markets and less a question of the loss of competitiveness, at least as far as the major exports were concerned. The fact that an advanced country like New Zealand had to face that problem should give the Board a better appreciation of the painful difficulties encountered by developing countries in the same field.

Mr. Zhang said that he was in general agreement with the staff appraisal. The wage-price freeze, which had been introduced in June 1982 as the main instrument of anti-inflationary policy, had only been partially lifted in February 1984. Although the wage-price freeze had proved to be remarkably effective in bringing down the rate of inflation, it had accentuated the intensity of some of the major underlying imbalances in the New Zealand economy. Such a development would only make the policy decisions relating to both demand management and structural changes in the postfreeze period more difficult.

The most compelling issue was that of wages and prices, Mr. Zhang considered. Apart from restraining the rise in wages and prices during the past 18 months, the wage-price freeze had greatly reduced inflationary expectations. To prevent inflationary catch-up in the coming months, the authorities should adopt restrictive fiscal and monetary policies, while insisting on wage restraint leading to economically sustainable wage settlements. It seemed evident that if the present stance of fiscal policy was maintained, the budget deficit would continue to grow. The Government had, however, already recognized the need to reduce the structural component of the deficit, and had committed itself to doing so in the medium term. On the wage front, the Government intended to ensure that only a moderate movement in wage rates would take place during 1984. On the other hand, the tripartite discussions had only made gradual progress, with many important issues remaining to be resolved; the prospect was therefore uncertain, and the Government expected a price increase of 6 percent in 1984/85.

The immediate prospects for recovery in the New Zealand economy were worrying, Mr. Zhang went on. The downturn in activity that had started in the first half of 1982 had not been reversed. Real income, which had already been falling, had fallen further after June 1982, with the impact of the wage-price freeze. An income-induced fall in consumption and stagnation in fixed invesment were the main elements of the current recession. On the other hand, the continued large budget deficit had acted as an expansionary factor and would continue to do so in the future. In the circumstances, the prospects for a strong recovery in 1984 did not seem very good. If monetary conditions were kept tight and the increase in the budget deficit was kept under control in the coming months, the increase in real income would probably be small, as would the rise in private consumption. As investment activity was likely to continue to be sluggish, domestic demand could not be expected to recover significantly, so that in the main the impetus for recovery would have to come from the export sector, where the market prospects for some of New Zealand's main trading partners, such as Japan and the United States, were improving. The growth of GDP would probably be small, while unemployment would rise.

There was also the problem of the external position, Mr. Zhang noted. New Zealand had experienced a rising current account deficit during recent years. On the trade side, the deficit largely reflected the increasing difficulties being encountered by New Zealand in maintaining market access with its major trading partners--the members of the European Communities--primarily because of protectionism that was beyond the control of the authorities. In the circumstances, devaluation--a cure suggested by the staff--could not be the proper instrument for solving New Zealand's export problems. However, if New Zealand were to increase its market shares elsewhere, it was important that the competitiveness of its exports should not fall during the postfreeze period. Unfortunately, the servicing of external debt had become an increasingly important element in the external deficit. Thus, the medium-term policy objectives for the external sector should be a steady growth of exports accompanied by prompter structural adjustment. The attainment of those objectives would depend upon the willingness of New Zealand's trading partners to reduce the impediments to market access for its goods.

In retrospect, Mr. Zhang concluded, the frequent changes in short-term policy in New Zealand during the past few years had reflected the different priorities given to the short-term targets for output, inflation, and external balance at different times. Changes had also had to be made in response to unexpected fluctuations in the world economy, which had proved to be one of the most important constraints in the implementation of domestic policy objectives. Looking ahead, the removal of some of the existing sizable imbalances in the economy would require the Government to adopt and pursue steady, consistent, and appropriate adjustment policies over the longer term. It was also to be hoped that the external environment would become more favorable.

The Deputy Director of the European Department, replying to questions, dealt first with the domestic economy. In response to Mr. Hirao, he did not believe that there was a danger that some freedom for small companies to raise prices would lead to a surge in price increases. Demand was not expanding strongly and he expected normal competitive pressures to act as a check on the behavior of such companies. Furthermore, the whole climate in New Zealand was very interventionist; if small companies tried to raise their prices substantially, they would run the risk of a reimposition of controls. In response to Mr. Moerke, who had inquired which prices were still affected by the freeze, he mentioned that a footnote on page 7 of SM/84/46 listed the commodities that had been exempted from the price freeze. With the exception of those goods, he assumed that all others might be administratively adjusted. As to the effectiveness of the forthcoming price surveillance scheme, he had suggested that in the short run it might work quite well, especially while an effective wage freeze remained in place. However, it was by no means sure how long such an arrangement could last. The staff fears had been admirably expressed by Mr. Ismael, who had shown that the rate of monetary expansion had far exceeded the rate of increase in nominal GDP in 1983/84, with the implication that the excessive creation of money was likely to threaten the whole wage-price position.

During the discussions preceding the 1982 Article IV consultation with New Zealand, the Deputy Director said in response to Mr. Wicks, the staff had gone much more deeply into the so-called major projects, and had covered many aspects, such as their efficiency, financing, and profitability. At that time the New Zealand authorities had assumed that the price of oil would be about US$32 a barrel, a figure that was considered reasonably cautious. As to who would bear the loss in the event of failure of the major projects, some of them were wholly private in character, while in other cases the financing debt was backed by government guarantees. Some of the data requested by Mr. Wicks would be found in SM/83/22.

Taking up questions regarding the financial policies of the New Zealand authorities, the Deputy Director responded that he could say nothing precise about interest rate policy after August 1984. In view of

New Zealand's history, however, it would not be altogether surprising if that policy continued unchanged after August 1984. A question had been raised as to why the tax to GDP ratio was so low in New Zealand. The answer was that the very narrow indirect tax base made it difficult to raise the figure.

In response to Mr. Moerke's question regarding the reasons for the success or failure of government debt tenders, the Deputy Director remarked that a new type of instrument had been offered; although it had not inspired confidence in the success of the Government's anti-inflationary policy, it probably had raised some extra money. Perhaps more important, the Government had made it plain in the third tender, which had been so unsuccessful, that 11 percent was the maximum interest rate that it was prepared to offer. When the Government fixed the rate in any tender system, the result was great market uncertainty. Consequently, for the fourth tender, the financial institutions had probably concluded that they might as well take up the stock voluntarily at 11 percent, because otherwise they would find themselves subjected to compulsory taking up of government debt.

Responding to questions on the external policies of the New Zealand authorities, the Deputy Director said that he could not specify the meaning of the heading "Other services" in Table 25 on page 42 of SM/84/46. Two of the elements were certainly the expenses of New Zealand firms abroad and official payments abroad other than debt interest. He would be in touch with the New Zealand authorities for a more comprehensive answer. As to why New Zealand had only devalued by 6 percent when Australia had devalued by 10 percent in March 1983, it could be said that the devaluation reflected broadly the weight of Australia in the New Zealand exchange rate basket. The New Zealand authorities had decided to go no further for the same reason that they had decided to freeze the exchange rate when the wage-price freeze had been introduced; they did not wish any extra impetus to inflation to be caused by a rise in import prices. While Ms. Bush's reference to the reduction of the credit rating of New Zealand by a U.S. agency was correct, it was interesting to note that in 1984 New Zealand had raised a loan on the Japanese capital market at a rate only fractionally above that paid by the World Bank. Looked at differently, it might be fair to say that the ease with which New Zealand could borrow abroad was not helpful in strengthening the determination of the authorities to overcome the country's difficulties.

Replying to Mr. Mtei's question regarding the justification for the staff recommendation that the New Zealand authorities should not reject the possibility of devaluing the New Zealand dollar, the Deputy Director remarked that the staff had given a fairly detailed explanation of why it thought that New Zealand needed to make a large external adjustment. It could be added that there was very little room for achieving external adjustment by reducing domestic demand. The New Zealand authorities had said that they recognized the need for an increase in competitiveness, and that they preferred to rely mainly on reducing relative domestic costs. If there was a difference between the staff and the New Zealand authorities on the point, it was not large; the staff did wish to underline, however, that it did not believe that the desired increase in competitiveness could be achieved only by reducing domestic costs.

With regard to Mr. Mtei's observation that most of New Zealand's difficulties had arisen from the growing trade restrictions in other countries--a point that Mr. Morrell had also mentioned--the Deputy Director recalled that at the time of the 1982 Article IV consultation, the staff had given a complete list of restrictions in an appendix to the report on recent economic developments. There seemed no reason to repeat the list, but the situation had certainly not improved.

Finally, the Deputy Director from the European Department stated that there had been outward migrations from New Zealand in the five-year period up to 1982/83, when the position had been reversed. The main reason for the swings was the relative state of the economy in Australia and in New Zealand. It was perhaps worth noting that at present the Australian economy was undergoing a strong upturn while that of New Zealand was not.

Mr. Morrell said that while most Directors had acknowledged the success of the wage-price freeze in reducing inflation, not many of them seemed to have approved of the device. They had moreover been concerned about the way in which the economy would come out of the freeze. They should remember that the wage-price freeze had been initiated in part because of the failure of the Government's efforts in wage negotiation, and it had followed a long period of high inflation that had certainly been stimulated by the system of wage settlement then prevalent in New Zealand. The Government had felt that there was a serious problem, and that it required a serious solution. Meanwhile, the Government had been continuing its negotiations with the parties, and the successful conclusion of those negotiations would have the greatest bearing on how the economy fared after the freeze. A number of Executive Directors had been concerned that the freeze would only suppress the inflationary tendencies and that they would re-emerge. However, if the Government was able to formulate a wage-fixing solution that would avoid passing through any price increases, it would have made a very significant gain, and the outcome would clearly have a bearing on price changes in the future. As to the sort of policies that would be followed in the price surveillance field when the interim arrangements were concluded, Directors should realize that the surveillance procedures were not new; both price surveillance and price control had been practiced in New Zealand in many forms at different times.

Several speakers had commented on the competitiveness of New Zealand's exports, Mr. Morrell noted. In that respect, the wage-price freeze had been of the greatest advantage, particularly in relation to Australia. It was perhaps inconsistent to oppose a wage-price freeze and at the same time to criticize the authorities for failing to pay sufficient attention to competitiveness. In addition, markets in Australia had been opened up for New Zealand's products by the recent closer economic arrangement with that country. As to the suggestion by Ms. Bush that New Zealand's pleas that trading partners should lower their barriers to New Zealand's export products would be more credible if New Zealand itself had a smaller array of protective devices, she should recognize that the closer economic arrangement with Australia had involved a significant reduction in protection between the New Zealand and Australian markets, without raising barriers against third parties.

There had been some comments to the effect that New Zealand's monetary policy had not been particularly tight during the period of the freeze, Mr. Morrell observed. His own view was that monetary policy had been quite tight throughout the freeze period. The authorities had followed an internal monetary guideline, which had provided a reasonably stable basis for monetary policy. It was true that the authorities had employed a vast array of instruments at different times, and that some of them were not particularly favored by the Fund. They were nevertheless being pursued with vigor, and many of the controls imposed on the banking system were even more severe than those mentioned by the staff in SM/84/40, Supplement 1. While it might well be true that the interest rate controls in place in New Zealand after August 1984 would be similar to those currently in place, Executive Directors should recall that when the present Government had come into office in 1976 it had carried out a major deregulation of the financial system and that, despite its present actions, it still publicly maintained that it intended to return to a deregulated structure.

As to the possible rate of economic growth in the near future, Mr. Morrell said that his authorities found the growth stronger than originally expected; the rate would probably be about 2 percent in 1984/85. While in the past New Zealand had on occasion been accused of promoting growth by fiscal stimulus, one significant influence for the future would be the situation in Australia, for which the Organization for Economic Cooperation and Development (OECD) was forecasting one of the highest growth figures among the industrial countries. The closer economic relations that New Zealand was enjoying with Australia provided a significant market for New Zealand's manufactured exports. There were therefore signs of real improvement in the New Zealand economy as a fallout from the recovery in Australia and the other major industrial countries.

It had been suggested by Mr. Ismael that the New Zealand authorities were being rather overoptimistic in their outlook regarding the rate of inflation in the 12 months following the end of the freeze, Mr. Morrell noted. His authorities had a number of reasons for their inflation forecast. There had been considerable gains in efficiency during the period of the freeze and the recession following the rationalization of industry. The same thing had taken place in the United Kingdom, where there had been considerable improvement in efficiency during the recession. As to whether there would be a low wage settlement in the near future, which would be a great help in keeping inflationary pressures down, he had learned very recently that the social partners had not agreed on such a settlement and that the unions would push for a large general wage order. The wage situation was in fact still serious, and the Government would need to employ very strong measures to bring an effective agreement into place.

However, there was relatively high unemployment in New Zealand and some underutilization of capacity, so that it was expected that there would be very little flow-through of price increases from more expensive imports.

Finally, Mr. Morrell commented on the question on migration raised by Ms. Bush. There was a completely free flow of people between New Zealand and Australia. There were no restrictions on work, and the only formality was a passport required for entering Australia. The movement of people between the two countries was often a barometer of economic perceptions. While there had been a reflow of people from Australia to New Zealand in the recent past, the forecasts were currently for better economic conditions in Australia. As to the actual flow of persons between the two countries, it was difficult to make official forecasts in a field that was completely unregulated.

The Executive Directors agreed to return at 3:00 p.m. for the Chairman's summing up at the conclusion of the 1983 Article IV consultation with New Zealand.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/84/36 (3/5/84) and EBM/84/37 (3/9/84).

4. ALGERIA - 1983 ARTICLE IV CONSULTATION - POSTPONEMENT

The Executive Board notes the request contained in EBD/84/68 (3/6/84). Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to extend the period for completing the 1983 Article IV consultation with Algeria to not later than April 18, 1984.

Decision No. 7644-(84/37), adopted
March 8, 1984

5. GRENADA - TECHNICAL ASSISTANCE

In response to a request from the Grenadian authorities for technical assistance, the Executive Board approves the proposal set forth in EBD/84/64 (3/2/84).

Adopted March 8, 1984

6. APPROVAL OF MINUTES

a. The minutes of Executive Board Meeting 83/132 are approved. (EBD/84/59, 2/28/84)

Adopted March 5, 1984

b. The minutes of Executive Board Meetings 83/133 through 83/135 are approved. (EBD/84/60, 2/29/84)

Adopted March 6, 1984

c. The minutes of Executive Board Meetings 83/136 and 83/137 are approved. (EBD/84/62, 3/2/84)

Adopted March 8, 1984

7. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/84/43 (3/5/84), EBAP/84/44 (3/6/84), and EBAP/84/46 (3/7/84) is approved.

APPROVED: August 24, 1984

LEO VAN HOUTVEN
Secretary