MASTER FILES

ROOM C-120 04

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/122

10:00 a.m., August 6, 1984

R. D. Erb, Acting Chairman

Executive Diretors	Alternate Executive Directors
	T. Ramtoolah, Temporary
	H. G. Schneider
	G. E. L. Nguyen, Temporary
	M. Teijeiro
	C. A. Salinas, Temporary
	D. C. Templeman, Temporary
	M. Lundsager, Temporary
	N. U. Haque, Temporary
	T. Yamashita
	K. Murakami, Temporary
	I. R. Panday, Temporary
R. K. Joyce	
	H. A. Arias, Temporary
	G. Grosche
	N. Coumbis
R. N. Malhotra	A. Vasudevan, Temporary
	J. E. Suraisry
	T. de Vries
G. Salehkhou	
F. Sangare	S. M. Hassan, Temporary
M. A. Senior	J. E. Rodríguez, Temporary
J. Tvedt	A. Lindø
	Wang E.
	Shao Z., Temporary

J. W. Lang, Jr., Acting Secretary
S. J. Fennell, Assistant

Also Present

African Department: M. W. Bell, F. d'A. Collings, A. C. Woodward. European Department: P. de Fontenay, Deputy Director; M. A. Evans, J. J. Hauvonen, P. L. Hedfors, W. L. Hemphill, H.-J. Huss, A. Knobl, S. Mitra. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; S. Mookerjee, Deputy Director; A. Abisourour. Fiscal Affairs Department: H. Bierman, L. Mutén. Legal Department: J. K. Oh. Research Department: N. M. Kaibni, E. A. Milne, A. Mullor-Sebastian, B. E. Rourke. Advisor to Executive Director: D. I. S. Shaw. Assistants to Executive Directors: H. Alaoui-Abdallaoui, J. Bulloch, D. Hammann, L. Ionescu, A. K. Juusela, E. Olsen, A. J. Tregilgas.

1. MALAWI - 1984 ARTICLE IV CONSULTATION; REVIEW UNDER EXTENDED ARRANGEMENT; AND PURCHASE TRANSACTION - COMPENSATORY FINANCING FACILITY - FLUCTUATIONS IN COST OF CEREAL IMPORTS

The Executive Directors considered the staff report for the 1984 Article IV consultation with Malawi and review under the extended arrangement for Malawi (EBS/84/151, 7/12/84), together with a request by Malawi for a purchase equivalent to SDR 13.8 million under the decision on compensatory financing of fluctuations in the cost of cereal imports (EBS/84/153, 7/12/84; and Sup. 1, 8/3/84). They also had before them a report on recent economic developments in Malawi (SM/84/177, 7/23/84).

The staff representative from the African Department made the following statement:

> As anticipated in the letter of intent and the attached economic memorandum dated June 25, 1984, a number of actions in support of the program have recently been taken.
>
> On July 27, the Government announced in the Malawi Government Gazette (General Notice No. 568) that applications for price increases are required for only 25 specified commodities. This action is in line with the understanding reached during the discussions in Lilongwe; it is understood that further revisions in the list of commodities subject to price controls will be implemented from time to time until, by June 1986 at the latest, only a very small number of goods will be controlled.
>
> On June 29, 1984, Special Local Registered Stock (SLRS) was issued to the two commercial banks, in exchange for the Government's assumption of the debt to the banks of Press (Holdings) Ltd. As of July 1, 1983, the effective date of the agreement restructuring the Press group, this debt amounted to MK 54.2 million and accordingly, in determining compliance with the performance criteria, the ceilings on credit to Government shown in Table 4 of EBS/84/151 will be increased by MK 54.2 million. No adjustment is to be made to total net domestic assets of the banking system on account of the issue of this stock.
>
> The authorities have supplied monetary data for end-June 1984 indicating that net domestic credit to the Government was MK 282.6 million and net domestic assets of the banking system were MK 546.6 million. Both figures are well within the ceilings expressed in EBS/84/151, as adjusted. It is worth noting that the monetary data also indicate a substantial improvement in the net foreign position of the banking system, which reflects a much-improved situation with regard to the shipment of exports and the prices realized for export crops compared with expectations formed during the discussions with the authorities in Lilongwe. This implies a higher rate of monetary expansion than

expected, and the staff will maintain close contact with the authorities to determine the need to make any downward adjustment to the indicative targets for December 1984 and March 1985, when performance criteria are established during the first review on the program for 1984/85.

The authorities have already announced increases in fertilizer prices, raising prices of the various grades by 11-20 percent. The authorities have, therefore, complied with commitments to the Fund and the World Bank to remove the subsidy on normal transportation routes through Mozambique before the 1984/85 growing season. However, because of the problems that still exist in making shipments through Mozambique, considerable amounts of fertilizer are still being shipped through other ports; the subsidy that is likely to be a charge on the budget in 1985/86 is estimated to amount approximately to MK 6 million. Producer prices that have been agreed, though not yet announced, represent substantial increases for most crops of 10-30 percent for tobacco, 6-33 percent for rice, 17-36 percent for groundnuts, 10 percent for cotton, and 15-67 percent for other crops such as oil seeds, cereals, and nuts. Since Malawi is now enjoying considerable export surpluses of maize, no further inreases are being made in maize prices for the forthcoming growing season. It is our understanding that these prices have been established using methodology developed in consultation with the World Bank.

Finally, the Malawian authorities have begun to monitor and report data for 1984/85 at monthly intervals for total expenditure, excluding debt service and for expenditure for wages and salaries. We asked that this monitoring be done on the basis of commitment data. However, it has proved impossible for the authorities to provide these data for earlier years. We have had discussions with the authorities on the path of the government expenditure, as provided for in the letter of intent. We regard the monitoring of government expenditure and the development of these expenditures as a matter of major importance and well in advance of the end of September (when there is another set of quantified performance tests), we intend to have further substantive discussions with the authorities. However, though there are still problems with the data, we can say, as I have already noted above, that on the basis of assessing the fiscal situation from the financing side, the fiscal program appears to be on target.

Mr. Sangare made the following statement:

Economic growth in Malawi turned out to be more vigorous than expected in 1983, with real GDP increasing by 4.4 percent, compared with the program target of 2.7 percent. There was also some improvement in the Government's financial position, although performance fell short of the targets set at the beginning of the program period. The external sector position remained weak relative to the previous year, primarily because of persistent interruptions in Malawi's trade routes to ocean ports and a sharp deterioration in its terms of trade. Consumer prices increased by about 15 percent, reflecting the impact of two devaluations of the kwacha, higher transportation costs, and relaxation of price controls.

The authorities are aware that in order to maintain the growth momentum, they have to make sustained efforts to mobilize additional resources to finance the required level of investment, along with improving the efficiency of investment and maintaining adequate incentives for producers. A public sector investment program has been developed in consultation with the World Bank with the emphasis on productive projects that can attract the maximum amount of external financing. The authorities have also decided to increase the share of development expenditure in productive areas and to strike an appropriate balance between the need to maintain existing projects and the requirements of new investments. With regard to incentives for producers, the authorities will continue to adjust upward as necessary the price of maize, and are considering substantial increases in prices for other crops for the 1984/85 season. The authorities also intend to limit to a few items the list of consumer commodities whose prices are subject to control. To reduce price distortions and enhance the free operation of market forces, the authorities have also agreed to consider removal of the remaining subsidy on fertilizers. However, they are concerned about the possible impact that a rapid shift in the incentive structure could have on the commodity pattern of production. In particular, the inherent bias against maize, the staple food, could lead to a substantial shift away from maize production, and hence a food shortage could develop, necessitating food importation.

Measures initiated to restore financial viability of the parastatals--including annual reviews of tariffs, managerial reform, and stricter financial controls--are beginning to show positive results. The financial position of these organizations improved in 1983, and most of them are expected to show a net profit in 1984/85. However, some enterprises are having difficulties in meeting their debt servicing requirements. In an effort to assist these enterprises, the Government has assumed the cost of servicing some of their debt obligations. In the Press Holdings group, a financial restructuring now under way is expected to be completed during 1984/85. Although the arrangement will entail additional costs on the budget, it is expected that the guidelines to be implemented will ensure profitability in the future.

The persistent problem along trade routes to sea outlets in Mozambique in recent years has fueled inflationary pressures by increasing the cost of imports, while delays in export shipments have affected the country's foreign exchange earnings. The authorities are therefore giving priority to developing alternative routes through the port of Dar es Salaam in Tanzania. This is an area where substantial financial and technical assistance from donor countries and multilateral institutions would be required. Meanwhile, a special task force has been established to monitor and coordinate trade movements to ensure the efficient use of available routes.

Revised budgetary estimates indicate that while all performance criteria on bank credit ceilings were met and some progress was made toward reduction of fiscal imbalances, the overall budget deficit in 1983/84 was higher than envisaged by about 1 percent of GDP. Revenue increased by 16.7 percent, compared with the program target of 11.7 percent, but this increase was more than offset by higher interest payments, the fuel subsidy for which the program had made no provision, and increased outlays by the Government in an effort to mitigate the effects of transport interruptions. The authorities are aware that in view of the present high rates of taxation, the high inelasticity of the tax system, and the limited scope of expanding the tax base, further improvements in the fiscal position would depend mainly on expenditure restraint and improvements in the performance of public corporations. Accordingly, special measures have been taken to limit the growth in expenditure in 1984/85, including the strengthening of monitoring and expenditure control procedures. A monthly reporting system is being put into effect. It is the Government's intention to continue its policy of wage restraint and the curtailment of public sector employment. Means by which subsidies can be gradually phased out are being considered. All of these, together with the new revenue package, are expected to keep the budget deficit within the original target of 5.4 percent of GDP in 1984/85.

Monetary and credit performance in 1983/84 was in accordance with the program objectives, and the growth in total money supply was less than envisaged in the program. While credit to the private sector exceeded the expected level, this excess was more than offset by a decline in credit to the public sector. Growth in the money supply will be limited to 10 percent in 1984/85, a rate considered adequate to meet the needs of expanding economic activity without increasing inflation, which is already high. The flexible interest rate policy adopted by the Malawian authorities has helped to ensure positive interest rates.

The balance of payments in 1983 was severely affected by several adverse developments over which the authorities had no control. Transportation problems resulted in exceptionally high import costs, while affecting the flow of exports. Malawi's terms of trade declined by 16.7 percent in 1983, reflecting low prices for tobacco and sugar, the country's main export commodities. Consequently, the current account deficit, which had been reduced from 23.4 percent of GDP in 1979 to 8.3 percent in 1982, rose to 11.5 percent of GDP in 1983, compared with the program target of 8 percent. Moreover, the heavy commercial debt repayments falling due in 1983 resulted in a debt service ratio of 22.1 percent after rescheduling. In addition, net capital inflow was lower than expected. The balance of payments is projected to be in line with the original program target in 1984. However, the above-mentioned adverse developments in 1983 have necessitated an upward revision of the target for the balance of payments deficit in 1985 and 1986.

Medium-term projections show that the decline in Malawi's terms of trade will moderate in 1984 and eventually recover in 1985. This development, coupled with the easing of the transportation problem, should help the balance of payments position to improve over the medium term. An equilibrium position is expected by 1987, one year later than planned.

The authorities intend to monitor the debt situation closely and refrain from further nonconcessional borrowing. However, they also intend to avoid further debt rescheduling in view of the direct and indirect costs involved. Malawi remains current on its debt obligations.

The flexible exchange rate policy pursued by the Malawian authorities in recent years has helped to improve competitiveness in the export sector. The authorities intend to continue with this approach. Malawi maintains an exchange and trade system free of restrictions on current international transactions.

Directors also have before them today a request by the Malawian authorities for a purchase of SDR 13.8 million under the compensatory financing facility. I have already referred to the adverse developments that have affected Malawi's balance of payments position in 1983. It should be stressed here that these factors, namely, transport interruptions and the decline in terms of trade, which affected export earnings, were beyond the authorities' control. Merchandise exports are projected to increase by 17 percent in 1984 and 12 percent in 1985, indicating the temporary nature of the 1983 export shortfall.

Malawi's cooperation with the Fund is evidenced by the extended arrangement now in place. The successful compliance with all the performance criteria under the first year of the arrangement, and the economic and financial policies for the second year that are before the Board today, are clear indications that the authorities intend to collaborate with the Fund in seeking solutions to their economic and financial problems.

Mr. Ramtoolah observed that economic developments in Malawi were satisfactory after one year of the extended arrangement, despite some unexpected slippages in the fiscal and external areas. Economic growth had been more vigorous than expected; monetary developments had been appropriate; credit had been redirected from the public to the private sector; positive real interest rates had been maintained to encourage the mobilization of domestic resources.

The slippages in the fiscal and external areas had been due, to a large extent, to the adverse external transportation situation, a problem that represented the single biggest threat to Malawi, Mr. Ramtoolah remarked. Transportation difficulties had caused inflation to be higher than expected in 1983 and had exacerbated the financial situation of the parastatals, thereby impeding a further improvement in their overall position. The external sector had also been affected: import prices had risen; export prices had fallen, especially of tobacco, the major export crop; and stocks, especially of sugar and tobacco, had accumulated. Consequently, the current account deficit had increased.

His chair welcomed the authorities' decision to establish a special task force to coordinate and monitor trade flows and to maximize the efficiency of available transportation routes, Mr. Ramtoolah went on. Given the adverse impact that the transportation problem could have on the long-term outlook for the economy, the authorities should increase their efforts to seek lasting solutions by developing alternative routes.

As for the second year of the extended arrangement, Mr. Ramtoolah continued, he welcomed the continuing emphasis on agriculture, particularly on the so-called smallholder crops other than maize, output of which was expected to increase significantly in 1984. He hoped that the emphasis on those crops would not be to the detriment of maize and tobacco production, given their good export prospects. His chair fully supported the authorities' cautious approach to fertilizer prices, in view of the prevailing difficulties with respect to external transportation. Indeed, during the Executive Board's discussion of the 1984 Article IV consultation with Ethiopia (EBM/84/90, 6/8/84) his chair had observed that the removal of fertilizer subsidies had had adverse consequences on agricultural output.

Greatest attention was required in the fiscal area, and expenditures should be kept in check, Mr. Ramtoolah suggested. He welcomed the establishment of ministerial and departmental monetary committees to strengthen expenditure control, which appeared warranted if the public sector deficit were to reach a sustainable level over the medium term.

On the external side, given the recent increase in debt servicing obligations, he welcomed the authorities' decision to restrain nonconcessional borrowing, Mr. Ramtoolah stated. The authorities also had devalued the kwacha by 15 percent in 1983 and early 1984, pegging it to a trade-weighted currency basket rather than to the SDR. He commended them for their liberal trade and exchange system. In conclusion, he supported the proposed decisions. All the conditions necessary to justify compensatory financing had been satisfied.

Mr. Grosche remarked that during the first year of the extended arrangement, Malawi's performance had been mixed. On the one hand, growth had been more vigorous than expected, monetary and interest rate policy had been satisfactory, and prices had been adjusted appropriately, particularly in the agricultural sector. On the other hand, the external imbalances remained, fiscal policy was inappropriate, and the parastatal enterprises were showing only a marginal improvement. Those more negative developments had been caused, in part, by factors beyond the authorities' control, including the ongoing transportation problem; they had also been caused by a lack of decisive adjustment efforts. Nevertheless, he could support the proposed decision, as all performance criteria had been met, some progress had been achieved, and the authorities had reaffirmed their commitment to continue cooperating closely with the Fund and to implement the necessary policies.

On fiscal policy, he shared the staff's concern regarding the higher than expected expenditure, Mr. Grosche commented. Total expenditure was estimated to have increased by more than 10 percent in 1983/84, more than double the programmed increase of 4.9 percent. Current expenditure alone had risen by 13.5 percent and the wage bill by 16 percent, although there had been no general wage increase. The 1984/85 budget did not allow for a marked reversal of that trend. All items, except for nonwage consumption, would increase rapidly. The wage bill was budgeted to rise again by 20 percent without any general wage increase, and was likely to increase by that magnitude again in 1985/86. If uncontained, the growth of expenditure could threaten Malawi's progress toward a viable balance of payments position. He concurred with the staff that expenditure, including subsidies, should be closely scrutinized during the next review of the extended arrangement. A further substantial increase in the already-high tax burden should be ruled out. On the positive side, it was commendable that the budget was being financed to a larger extent through the domestic nonbank sector.

The performance of parastatal enterprises was another cause for concern, Mr. Grosche remarked. Although the deficit of parastatals had been reduced slightly, the overall performance was still unsatisfactory. Little progress had been made in keeping prices and tariffs at an appropriate level and in further restructuring the Press Holdings group. The recent tariff adjustment and the forthcoming annual review of tariffs and prices were steps in the right direction. However, the review would be useful only if the Government was seriously committed to a thorough rehabilitation of the parastatal sector.

As for external policies, he welcomed the authorities' commitment to a flexible exchange rate policy and an open trading system, Mr. Grosche said. However, the current account situation remained difficult. As the terms of trade were projected to deteriorate further in 1984 and the transportation problem would remain, the prospects for an improvement in the current account during the remainder of the program were worse than originally foreseen. Although some relief would be provided through a significant increase in capital inflows, the external situation allowed no leeway in the conduct of domestic policies. Could the staff elaborate on the nature of the transportation problem and how and when it might be tackled?

On structural policies, agriculture was the backbone of the economy, Mr. Grosche observed. The adequacy of the policies pursued thus far was reflected by improvements in the rural-urban terms of trade and in the real rate of return of agricultural activities. However, agricultural performance had been mixed in 1983, and its contribution to overall economic activity would decrease in 1984 compared with previous years. The annual review of agricultural producer prices was important, and he encouraged the authorities to provide further incentives for diversification, in order to reduce the economy's dependence on climatic conditions and changes in demand from export markets. In a broader structural setting, he was pleased to note that the authorities had removed all price controls, except for those on a few essential items; further progress was desirable. The freeing of prices had probably contributed to the increase in inflation; but that effect could have been at least partly mitigated by greater expenditure restraint.

Finally, he welcomed the close cooperation between the Fund and the World Bank on Malawi's structural adjustment program, Mr. Grosche stated. The authorities should reduce the expenditure devoted to the construction of government buildings, but he was pleased to note that domestic funding of the structural adjustment program might be increased.

Ms. Lundsager indicated her support for the proposed decisions relating to the program for the second year of the extended arrangement and the request for a purchase under the compensatory financing facility. While her authorities retained their reservations on the appropriateness of an extended arrangement for Malawi, especially in view of the missed targets in 1983, they recognized that the decline in the terms of trade and the external transportation problems had complicated the country's adjustment effort. Those problems had apparently explained the wider than expected trade and current account deficits in 1983. Table 5 of EBS/84/151 showed that the cost in 1983 of transporting virtually the same f.o.b. value of imports as in 1982 had been SDR 27 million greater, indicating that the higher than expected real economic growth in 1983 had not manifested itself in the external account.

Highlighting the improvements accomplished so far under the program, Ms. Lundsager noted that the continuing liberalization of prices had had favorable effects on production, as evidenced by the large surplus of maize for export in 1983 and 1984. She urged the authorities to continue increasing agricultural prices paid to farmers until prices reached the export parity level. While that action would reduce the profitability of the Agricultural Development and Marketing Corporation (ADMARC), its favorable impact on the economy--higher production and growth, more exports, and fewer imports--would far outweigh the declining profitability of one government agency. She noted with approval the Bank/Fund cooperation on Malawi's investment program and hoped that the structural adjustment loan would help the authorities to increase the efficiency of investment.

Her major reservations with the program lay in the fiscal and monetary spheres, especially as they influenced overall savings in Malawi, Ms. Lundsager indicated. She had been disappointed by the wider than programmed public sector deficit and the concomitant increase in both domestic and foreign financing. Current expenditure had risen by 13.5 percent in 1983/84, greater than the programmed increase of 4.4 percent. She welcomed the elimination of the fuel subsidy but urged the authorities to impose additional expenditure controls, especially on subsidies, and to exercise greater restraint in public sector hiring so as to reach the original deficit target of 5.5 percent of GDP in 1984. As an additional control on the public sector, the staff, when establishing performance criteria for December 1984 and beyond, should consider redefining the criterion limiting credit to the Government to include nonbank as well as bank financing.

Neither the nonbank institutions that served as depositories for rural savings--the Post Office Savings Bank, which held remittances of migrant workers, and the new Building Society--nor the commercial banks had offered meaningful positive real rates of interest on deposits in 1983, Ms. Lundsager observed. Without further increases in interest rates, it might be difficult to generate the additional savings necessary for private sector development, even assuming that the Government reduced its borrowing from savings institutions. While foreign assistance had an important role to play in a developing economy such as Malawi's, domestic savings were also required to free the local resources that must work in conjunction with the external resources.

As for the external sector, the outlook for reaching a sustainable payments position was bleak, Ms. Lundsager noted. Nevertheless, the Malawian authorities hoped to eschew future debt rescheduling owing to its high cost, a goal that she endorsed. She hoped that the new projections indicated to the authorities the need to adhere to their adjustment program, even beyond the expiration of the extended arrangement. Finally, their commitment to maintaining an open trading system and a flexible exchange rate was commendable.

Mr. Clark, commenting on the general progress of adjustment in Malawi, noted that the external environment had been hostile. Malawi had suffered as a result of the weak world economy and the consequent decline in demand for many export commodities, as well as from problems associated with the shipment of its traded goods. Therefore, despite the introduction of some significant measures by the authorities--particularly in pricing--adjustment had been comparatively modest, and significant imbalances remained. Nevertheless, he commended the authorities for having achieved a reasonable rate of domestic growth, which had reached 4.5 percent in 1983, and for having met the performance criteria for the first year of the extended arrangement.

The imbalances in the economy would have to be reduced significantly if Malawi were to achieve a sustainable external position in the medium term, Mr. Clark considered. The staff had indicated that the overall balance of payments could move into surplus by 1987, barring further external shocks. To achieve a balance of payments surplus with any certainty would require great determination on the part of the authorities. He agreed with the staff that they would probably have to intensify their adjustment efforts soon if the program were to stay on track, especially if no external debt rescheduling were planned for 1984, and he welcomed the authorities' intention to take any further measures that might become necessary.

On fiscal policy, Mr. Clark noted that the central government budget deficit in 1983/84 had exceeded the program target. The new measures being introduced to improve control over public expenditure were welcome; they should work as control mechanisms, not just monitoring mechanisms. Since scope for further increases in tax revenue seemed to be limited, it was all the more necessary to avoid expenditure overruns, particularly with regard to public sector wages. Would it be possible to relieve pressures on the budget by delaying nonessential investment, for example, in government buildings? He welcomed the progress made in strengthening the parastatal enterprises and in reconstructing the Press Holdings group.

Monetary developments in the first year of the program had been broadly in line with expectations, and he commended the authorities for pursuing a flexible interest rate policy, Mr. Clark went on. The staff proposed to establish credit ceilings as performance criteria only for the first two quarters of the second year of the program, leaving December 1984 and March 1985 ceilings as indicative targets, subject to modification at the midyear review. Although the practice of fixing performance criteria near the time of their effective date should generally be avoided, he could go along with the staff's proposal because of their specific link to the timing of disbursements under the World Bank's structural adjustment loan. He welcomed the close collaboration between the Fund and the Bank in maintaining Malawi's adjustment effort.

As for supply-side measures, the authorities should be commended for having improved price incentives to producers, Mr. Clark considered. The benefits of price liberalization had been demonstrated by the increases in agricultural output over the past few seasons. Any future price increases should take account of the general rate of inflation, if the incentive effect were to continue. He hoped that the authorities would establish appropriate relative prices for crops with considerable export potential such as cotton, groundnuts, rice, and tobacco. The authorities had recently responded to favorable market conditions for maize and had increased exports of that commodity. However, the demand for maize might decline once the present exceptional circumstances of the region were relieved. It was therefore important to promote agricultural diversification.

More generally, he welcomed the authorities' commitment to move toward price decontrol, Mr. Clark remarked. They had already taken a significant step in the right direction by reducing the number of items subject to control. Could the staff indicate the proportion of expenditure that was covered by the remaining price controls on 25 commodities?

The authorities were intending to make further progress on decontrol by the end of the year, and the midterm review would be an opportune time to assess the results and to determine the timetable for the removal of the remaining subsidies.

On the external side, the transportation problems were adversely affecting Malawi's balance of payments position and adjustment prospects, Mr. Clark observed, and he welcomed the establishment of a special task force to tackle the issue. In the context of the Fund program, it would be helpful if the staff could present a comprehensive assessment of the current effects of increased transport costs. To what extent could those higher costs be passed through to prices?

Malawi's external debt service ratio was high, and there was a need for a cautious debt policy, Mr. Clark stated. The authorities should be commended for having refrained from contracting new nonconcessional loans in 1983. The debt monitoring unit established in the Ministry of Finance should be helpful in promoting such caution.

He welcomed the authorities' continued pursuit of a flexible exchange rate policy and their maintenance of a liberal trading system, Mr. Clark commented. They should be complimented for their performance under the first year of the extended arrangement, particularly given the adverse external developments. However, they would need to improve the financial performance of the public sector during the second year of the program if the overall objectives of the extended arrangement were to be realized. In conclusion, he could support the proposed decisions.

Mr. Joyce stated that he supported the proposed decisions. Although all the performance criteria in the first year of the program had been met, he was concerned that the deficits of the Central Government and on the current account had exceeded the targets for 1983. A weaker than expected performance of the public sector had contributed to those deviations, which had not been entirely the fault of the authorities. He welcomed the statement by the staff that there were indications of a firming of tobacco prices and some improvement in the transportation situation.

Progress should continue to be made toward improving the quality of the medium-term adjustment, especially with respect to the overall financial performance of the Central Government and the parastatals, Mr. Joyce considered. It would be essential to restrain government expenditure, especially recurrent expenditure, as capital development expenditure had fallen below the program target. The increase in the size of the public service in 1983 had resulted in a significantly higher wage bill; it was therefore all the more important for the authorities to exercise wage restraint in 1984/85.

It was equally essential that subsidies be curtailed further, Mr. Joyce commented. He welcomed the steps already taken to eliminate subsidies and increase producer prices. Although the removal of subsidies might have some adverse short-term effects, for fiscal and economic reasons, the authorities should proceed in that direction forcefully. On a related point, as possibilities for further increases in revenue were not great and the rates of taxation were already high, the authorities needed to act firmly on the expenditure front.

With respect to monetary policy, Mr. Joyce went on, it was disappointing that inflation had increased to 15.4 percent in 1983, a rate 2.4 percent higher than programmed. However, he was encouraged that the authorities had increased deposit rates and that most interest rates had become positive in real terms, a factor that should help to mobilize domestic resources through increased savings and to ensure that domestic resources were allocated efficiently. In addition, he welcomed the exchange rate and trade policies being pursued.

He agreed with the staff that the emphasis in the medium term should be placed on improving the efficiency of investment, Mr. Joyce remarked. He welcomed the close cooperation between the Fund and the Bank in assessing the appropriateness of investment policies. Although it was essential in the short term to bring government expenditure firmly under control, it was equally important for Malawi's future that short-term resources were invested in the most effective manner. In conclusion, he could support the decision relating to the program for the second year of the extended arrangement, although discussions between the staff and authorities prior to the midyear review would be crucial.

Mr. Morrell said that despite difficult circumstances some progress had been made in addressing a number of Malawi's major policy problems during the first year of the extended arrangement. As other Directors had noted, much remained to be done in the second year of the extended arrangement. He endorsed the staff appraisal and supported the proposed decisions.

Although economic growth had been stronger than forecast, the fiscal and external accounts had been substantially worse than projected in the second year of the program, Mr. Morrell noted. While external developments had been largely outside the control of the authorities, the Government must take responsibility for the deterioration in fiscal conditions. He was concerned about the relatively slow implementation of effective policies aimed at minimizing the sensitivity of the Malawian economy to the vagaries of international markets. He therefore agreed with the staff that Malawi's policy efforts needed to be directed toward establishing appropriate incentive schemes, allowing market forces to operate more freely, and ensuring that a sustainable framework for public sector financing was maintained.

The agricultural sector held great promise for growth but was also the source of the economy's vulnerability to external developments, Mr. Morrell observed. Appropriate pricing signals were, therefore, necessary to ensure that the upward trend in agricultural output continued and to encourage diversification of agricultural production. Resources must be attracted to those uses with the most long-term potential. In that respect, it was vital that prices paid to producers of crops moved toward parity with export prices and that prices of inputs reflected opportunity costs. The adjustment program did include measures to increase agricultural prices and to reduce further the number of goods and services subject to price control, but he was concerned about the authorities' apparent reluctance to recognize the importance of appropriate public enterprise pricing policies. The success of Malawi's adjustment program hinged on the authorities' policy actions, improved markets for Malawi's exports, better access to transportation, and additional external assistance.

On fiscal policy, the higher than projected expenditure in 1983 indicated the need for additional restraint, Mr. Morrell stated. The revenue system was overburdened, and Malawi's balance of payments prospects had deteriorated. Because the programmed reduction in the deficit in 1983 had been rather modest, the overshooting in that year was all the more disappointing. A sharp increase in expenditure on wages and salaries had contributed significantly to that overshooting. A tight wage policy could be beneficial only if accompanied by restrained hiring practices. He therefore agreed with the emphasis that the staff placed on controlling expenditure, which should be curtailed to about 1-2 percent of GDP, to strengthen the budgetary position. The expenditure side of the budget presented by the authorities was too generous for all categories except nonwage consumption.

The program for 1984/85 needed to center on limiting the budget deficit to 5.4 percent of GDP, as envisaged in the original program, Mr. Morrell continued. Efforts must be made to curtail subsidies, restrain government wage expenditure--particularly by tightening recruitment policy--and postpone low-yielding public investment projects attracting little external finance. He welcomed the authorities' commitment to limit increases in the wage bill by containing the increase in overall public sector employment and to improve monitoring of expenditure. He remained concerned about public sector investment and urged the authorities to reconsider the magnitude of the allocation for government building.

The program appeared appropriate with respect to monetary and external policies, Mr. Morrell commented. He particularly welcomed the authorities' decision to keep external borrowing within the country's debt servicing capacity. While Malawi's debt service ratio had declined as a result of rescheduling, it was still high and was expected to remain so until the end of the 1980s. On the monetary side, had nominal interest rates been sufficient to induce the desired level of savings?

Mr. Suraisry indicated his general agreement with the staff appraisal. He could support the proposed decisions, including the decision on the compensatory financing facility. The performance of the economy under the first year of the extended arrangement had been disappointing, even though all performance criteria had been met. The fiscal and balance of payments deficits had been larger than expected, despite the improvement during the two years prior to the adoption of the program. Economic growth had been greater than programmed, but when adjusted for changes in the terms of trade, that growth appeared less impressive. Agriculture and manufacturing had responded favorably to the commendable price liberalization measures taken by the authorities, but the response had been uneven, particularly in agriculture. Price liberalization had been biased toward certain agricultural crops and had therefore led to an oversupply of those crops at the expense of others. Transportation difficulties had hindered the authorities from taking full advantage of the big increase in output of some products. External factors, such as worsening terms of trade and transportation problems, largely explained the unfavorable outcome in the first year of the program.

However, domestic factors had also affected economic performance, Mr. Suraisry went on. In particular, current expenditure, which had increased by 13.5 percent in 1983/84, compared with the program objective of 4.4 percent, had offset the impressive increase in total revenue. Revenues had not contributed to reducing the fiscal imbalances. The overall deficit of the Central Administration had not declined in 1983/84. Despite external developments, the authorities had no alternative but to strengthen their adjustment efforts.

The marked increase in output of some agricultural crops, owing to the introduction of price liberalization measures, had been achieved at the expense of other crops, especially smallholder crops, Mr. Suraisry noted. He was therefore pleased to note that that imbalance would be corrected during the remainder of the program. Because of the difficult conditions for agricultural production in neighboring countries, and the large increase in agricultural output in Malawi, the authorities had an opportunity to improve the country's external position. He encouraged the authorities to take full advantage of that opportunity by pursuing appropriate policies, not only on the supply side, but also on the demand management side.

As the room for increasing tax revenues was limited, the fiscal imbalances ought to be reduced by increasing nontax revenue and controlling expenditure, Mr. Suraisry indicated. Improving the financial position of the public enterprises, by increasing their efficiency and price flexibility, was of particular importance if a meaningful increase in nontax revenue were to be achieved. The authorities should exercise firm control over expenditure, particularly on wages, and refrain from any unnecessary spending that would strain the external position and create inflationary pressures. In that context, he welcomed the authorities' decision to modify their stance on wage policy and their proposal to establish a monitoring committee to review expenditure and monetary allocations.

With respect to the public sector investment program, he shared the staff's concern about the magnitude of the allocation for government buildings relative to the allocation for higher-priority sectors, and he endorsed the World Bank's view on that matter, Mr. Suraisry said. Given the present stage of adjustment and the restructuring of the supply side of the economy, it was essential that scarce investment resources be allocated more efficiently.

On external adjustment, the authorities had revised upward the current account deficit for 1984-86, Mr. Suraisry noted. Even so, the staff assumed an average annual growth rate of exports of 14 percent. Achievement of that growth rate depended on the weather in Malawi and in neighboring countries, and on the authorities' ability to maintain the country's competitive position and pursue the price reform recently initiated. He welcomed the comments of the staff at the present meeting regarding price liberalization measures.

The debt service ratio was high and represented a burden on the external payments position, Mr. Suraisry remarked. Like many agricultural countries, Malawi was vulnerable to changes in weather. It was therefore important for the authorities to leave some room for additional borrowing during difficult periods. In that respect, the performance criterion on borrowing was particularly appropriate. In conclusion, he commended the authorities for maintaining a liberal exchange and trade system, and for their determination in implementing the program.

Mr. Salehkhou observed that Malawi's economic performance in the first year of the extended arrangement had been generally below expectations, despite the significant acceleration of real growth in 1983 resulting from the continued expansion of agricultural output and a better than projected recovery in the manufacturing sector. The positive performance in the real sector had not, however, led to an improvement in Malawi's domestic or external financial position, which had been adversely affected by a number of exogenous developments, including a sharp deterioration in the terms of trade and a further worsening of Malawi's transportation difficulties. The poor financial performance had also been related, although to a lesser extent, to insufficient adherence to the program's restraint policies, particularly in expenditure control.

Significant progress had, however, been made by the authorities toward other objectives of the program, particularly with respect to structural adjustment, Mr. Salehkhou went on. While financial performance had been worse than expected, it was encouraging that both the fiscal deficit and the external current account deficit had been curtailed and that all performance criteria relating to credit from the banking system had been observed. The additional financing necessary as a result of the larger than projected budget deficit had been secured mainly through nonbank domestic resources.

Progress by Malawi had been particularly commendable in economic liberalization and in the use of more financial, rather than regulatory, policy instruments to attain the program's objectives, Mr. Salehkhou commented. The pricing system had been improved through an easing of government price control. Additionally, producer prices had been more actively used as production incentives in the agricultural sector to stimulate market production by smallholders, improve the pattern of output, and accelerate the recovery and expansion of agricultural production and exports. More appropriate exchange rate and interest rate policies had also been implemented to improve Malawi's competitive position and reduce the amount of capital flight. Finally, important reforms aimed at restructuring and streamlining public enterprises and Press Holdings group had been introduced and had begun to yield encouraging results through improved management, more appropriate parastatal tariffs, more efficient use of capacity, cost reduction, and investment surveillance.

However, despite a series of Fund-supported programs, cooperation with the World Bank, and fairly satisfactory implementation of agreed policies under the present program, only limited progress had been made toward achieving a viable balance of payments position, Mr. Salehkhou noted. Moreover, the prospects for attaining the program's overall targets did not seem promising and would probably necessitate an acceleration and a broadening of domestic adjustment. The lack of progress toward a viable balance of payments position had clearly been affected by such exogenous developments as a severe deterioration in the terms of trade, serious transportation bottlenecks, and a stagnation of grants and concessional flows.

Nevertheless, a more decisive reduction of the fiscal deficit and a continued improvement in the financial operations of the public enterprises would go a long way toward containing pressures on the balance of payments and achieving the program's original objectives, Mr. Salehkhou stated. He therefore welcomed the authorities' decision to concentrate their efforts on the expenditure side of the budget, in view of the overburdened tax system. The establishment of ministerial and departmental monitoring committees and the monthly monitoring of wage and total expenditures should help to eliminate the considerable expenditure overruns experienced in recent years. He also welcomed the authorities' agreement to implement more restrictive recruitment and wage policies and their intention to re-examine, in consultation with the World Bank, the public sector investment program to make it more compatible with the objectives of the program and to eliminate low-yielding and insufficiently financed projects.

He broadly concurred with the thrust of the staff appraisal and supported the proposed decisions on the 1984 Article IV consultation, the review of the program for the second year of the extended arrangement, and the request for a drawing under the compensatory financing facility, Mr. Salehkhou concluded. The circumstances of the shortfall in export earnings--lower commodity prices and severe transport difficulties--had been largely due to factors beyond the authorities' control. Furthermore, the calculation of the compensable amount took into account both the stock accumulated during the shortfall year and the shortfall in cereal imports, and it was based on actual data. There was therefore no risk of overcompensation.

The staff representative from the African Department remarked that the Malawian authorities had exercised caution with respect to the reduction in fertilizer subsidies, as they did not wish to repeat the experience of 1981, when there had been a considerable grain shortage. However, although the subsidy on fertilizer had undoubtedly contributed to an increase of maize production and exports, the net value added of maize production had been relatively small. The World Bank staff was of the opinion that further reductions in fertilizer subsidies would generally benefit the economy and would shift smallholder production in a direction that would benefit the balance of payments and the budget.

On the transportation problem, he could not add to the discussion on pages 14 and 16 of SM/84/177 and on page 21 of EBS/84/151, the staff representative indicated. The staff had been impressed by the authorities' decision to establish a special task force to deal with the problem. Alternative transport possibilities were being analyzed, and goods were being transported in the most economic and expeditious way. Export volume had increased partly because of an easing in transportation difficulties and partly because of the authorities' efforts.

He noted the proposal to include performance criteria on nonbank financing in the program, the staff representative commented, but the staff considered that some aspects of such performance criteria would not be entirely advantageous. The staff would examine the proposal in the context of the further implementation of the extended arrangement.

As to the query about the coverage of price controls, the staff representative said, they impinged most heavily on the manufacturing sector, which represented about 12 percent of GDP. On that basis, it seemed possible that existing price controls covered some 6 percent of GDP.

The staff had reached agreement with the authorities on the need to maintain strict control over expenditure on wages, the staff representative from the African Department concluded. With respect to expenditure on government buildings, in any future structural adjustment loan to Malawi the World Bank staff would recommend that approval of the public sector investment program should be made conditional on prior agreement of budget appropriations for state construction of houses. The Fund staff agreed that that was a sensible approach and would stress in its next discussions with the authorities that such low-priority investment expenditure should be kept to a minimum.

Mr. Sangare remarked that his authorities shared Directors' concerns that expenditure had been higher than targeted. That unfortunate development had resulted from increased interest payments that had exceeded the amount provided for under the program and from other expenditure necessitated by the exceptionally high transportation costs, prices of fuel, and other production inputs. However, the authorities had introduced special procedures to strengthen the monitoring of control expenditure. Moreover, wage restraint and employment curtailment, together with the gradual removal of the remaining subsidies and the better financial position of the parastatals, were expected to improve the fiscal position. With respect to investment expenditure, the authorities intended to increase the share of expenditure allocated to productive projects and would continue to review their investment program.

Malawi's external performance had fallen short of expectations, owing largely to the sharp deterioration in the terms of trade, Mr. Sangare acknowledged. Malawi's current account deficit had recorded a continuous decline from 23.4 percent of GDP in 1979 to 8.3 percent of GDP in 1982, clearly indicating that the 1983 rise had been the result of the unexpected fall in prices of Malawi's main export commodities and the persistent transportation problem. However, the authorities were giving particular attention to that problem, both within the framework of a subregional organization with neighboring countries, and individually trying to rationalize and improve existing transportation facilities. If Malawi's terms of trade improved in the future, as expected, the declining trend in the current account deficit would be restored.

His authorities were aware of the high debt service ratio, Mr. Sangare commented. They intended to refrain from nonconsessional borrowing and were committed to monitoring the debt situation closely. Malawi was meeting all its debt obligations.

Finally, the Malawian authorities expected the staff to be flexible, given the problems facing them in their efforts to implement the adjustment program, Mr. Sangare said. The structural nature of the balance of payments problems facing Malawi, and other developing countries, could be addressed only in the context of a medium-term arrangement. The success achieved thus far should encourage the Fund to adopt a more liberal attitude toward extended arrangements. The authorities were firmly committed to implementing all necessary measures to ensure achievement of the program's objectives. They were determined to prove that a medium-term arrangement was more suitable for addressing the structural problems of their economy.

The Acting Chairman made the following summing up:

> Directors generally agreed with the staff appraisal. They welcomed the continuation of economic growth in spite of the prolonged disruptions in the traditional external transportation routes and a deterioration in the terms of trade. This economic growth had been promoted by an expansion of agricultural output and related industrial activity, and had also reflected the adoption of more appropriate policies, including higher agricultural producer prices and a flexible exchange regime. Furthermore, price flexibility, including substantial increases in producer prices, should provide stronger incentives for agricultural production and diversification, and thus promote the attainment of an appropriate balance between export and domestic food crops.
>
> Executive Directors noted that, although the growth of net bank credit to the Government had been contained within program limits during 1983/84, there had been a larger than expected use of domestic nonbank financing and net foreign capital receipts. Directors expressed concern that the overall government deficit had exceeded the programmed target, largely because of recurrent

expenditure overruns. As Malawi's tax burden was already high, most Directors strongly emphasized the need to concentrate on expenditure control. Directors urged the authorities, in particular, to exercise much greater control over wage expenditure, especially by limiting increases in the number of government employees. In addition, there was mention of the need to reduce and curtail government subsidies. It was desirable to provide government resources for essential and current services to maintain the investment structure, but Directors called for a more prudent approach to investment policy. Directors welcomed the authorities' intention to observe the original program target for 1984/85 and the importance now attached to the measures for strengthening the Government's procedures for expenditure control.

Directors observed that the balance of payments had deteriorated in 1983, relative to both the previous year's outturn and the target included in the program. Although this deterioration had been partly due to the temporary delays in export receipts and capital flows, the balance of payments deficit in 1985 and 1986 was expected to be significantly larger than originally forecast, mainly because of the weaker terms of trade, somewhat lower capital receipts, and a continuation of a high debt service ratio. Thus, more significant adjustments, including stronger fiscal adjustment than originally programmed, would likely be required in 1985/86. Directors noted the Malawian authorities' intention to avoid further debt rescheduling, and commended the authorities for following a cautious external borrowing policy, given the high debt servicing prospects.

A large number of Directors stressed the need to continue to address Malawi's structural problems in order to achieve sustainable economic growth. In this regard, the significant progress toward price liberalization was welcomed. Further decontrol, together with appropriate adjustments of agricultural producer prices and the continuation of flexible interest rate and exchange rate policies, would be necessary to improve production incentives. Regarding interest rates, a number of Directors emphasized the importance of achieving and maintaining positive real interest rates, including those in nonbank financial institutions. Measures to strengthen the financial position of key productive enterprises in the parastatal sector, particularly the decontrol and improvement of their prices and tariffs, were also seen as being essential to increasing productive investments and domestic savings efforts.

Directors urged Malawi to continue to address its structural problems in a flexible manner and encouraged the continuation of appropriate consultations between the Fund and the World Bank. A number of Directors hoped that the World Bank's involvement would help to improve the efficiency of investments and noted in particular the need to reduce the share of construction devoted to government buildings. They emphasized the importance of investing Malawi's limited resources in productive investments, and the need to avoid low-yielding projects.

Directors commended the authorities for maintaining a liberal trading system and an exchange system free of restrictions.

It is proposed that the next Article IV consultation with Malawi should be held on the standard 12-month cycle.

The Executive Board then took the following decisions:

Decision Concluding Article XIV Consultation

1. The Fund takes this decision in concluding the 1984 Article XIV consultation with Malawi in the light of the 1984 Article IV consultation with Malawi conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes with satisfaction that Malawi continues to maintain an exchange system that is free of restrictions on payments and transfers for current international transactions.

Decision No. 7775-(84/122), adopted
August 6, 1984

Review Under Extended Arrangement

1. Malawi has consulted with the Fund in accordance with paragraph 4(b) of the extended arrangement for Malawi and paragraph 34 of the memorandum attached to the letter from the Minister of Finance and the Governor of the Reserve Bank of Malawi dated July 29, 1983, attached to the extended arrangement for Malawi (EBS/83/183, Supplement 1, 10/13/83), in order to reach understandings with the Fund regarding policies and measures that Malawi will pursue through March 31, 1985.

2. The letter dated June 25, 1984 from the Minister of Finance and the Governor of the Reserve Bank of Malawi together with an accompanying Economic Policy Memorandum shall be attached to the extended arrangement for Malawi, and the letter dated July 29, 1983 together with the accompanying Economic Policy Memorandum shall be read as supplemented by the letter dated June 25, 1984 together with the accompanying Economic Policy Memorandum.

3. Malawi will not make purchases under the extended arrangement that would increase the Fund's holdings of Malawi's currency in the credit tranches beyond 25 percent of quota or increase the Fund's holdings of that currency resulting from purchases of borrowed resources beyond 12.5 percent of quota

(a) during any period in which the data at the end of the preceding period indicate that

(i) the ceiling on the net domestic assets of the banking system as specified in paragraphs 23 and 24 of the Memorandum attached to the letter dated June 25, 1984; or

(ii) the ceiling on the net credit to the Government of the banking system as specified in paragraphs 23 and 24 of the Memorandum attached to the letter dated June 25, 1984; or

(iii) the limit on external borrowing as specified in paragraph 27 of the Memorandum attached to the letter dated June 25, 1984,

has not been observed; or

(b) during any period after December 31, 1984, until the review with the Fund contemplated in paragraph 31 of the Memorandum attached to the letter dated June 25, 1984 has been completed, or, following that review, while any performance criteria established by the Fund pursuant to the review are not observed.

4. Until April 30, 1985, purchases under this arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 45 million provided that purchases shall not exceed the equivalent of SDR 27 million until October 31, 1984 and the equivalent of SDR 34 million until January 31, 1985.

Decision No. 7776-(84/122), adopted
August 6, 1984

Purchase Transaction - Compensatory Financing Facility - Fluctuations in Cost of Cereal Imports

1. The Fund has received a request from the Government of Malawi for a purchase of SDR 13.8 million under the Decision on Compensatory Financing of Fluctuations in the Cost of Cereal Imports (Executive Board Decision No. 6860-(81/81), adopted May 13, 1981, as amended).

2. The Fund notes the representation of Malawi and approves the purchase in accordance with the request.

3. The Fund waives the limitation in Article V, Section 3(b)(iii).

Decision No. 7777-(84/122), adopted
August 6, 1984

2. SWEDEN - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with Sweden (SM/84/167, 7/13/84). They also had before them a report on recent economic developments in Sweden (SM/84/179, 7/23/84).

Mr. Lindå made the following statement:

On the whole, my Swedish authorities are in agreement with the staff appraisal of the present situation and the prospects for the Swedish economy. They have, however, supplied some comments in order to further clarify certain aspects.

One point on which the Swedish authorities and the staff have differences in interpretation is the degree of strain on productive capacity, to which the recovery of activity has led. According to my Swedish authorities, the strains in the economy are felt not primarily on productive capacity but rather at the level of wage formation generally in the economy: according to the latest business survey published in July, a clear majority--55 percent--of companies still report that demand is the most important restraining factor for production, whereas only 25 percent and 7 percent, respectively, report productive capacity and labor supply as restraining factors. These figures are quite low in historical perspective, especially as regards labor as a constraining factor, and are substantially below peak levels in previous upturns. In the view of my authorities, the fact that capacities are not being used to a higher degree, despite the rise in industrial production of more than 10 percent since the third quarter of 1982, provides an eloquent illustration of the low level of capacity utilization at the time of the 1982 devaluation. However, at the same time as only 7 percent of companies report shortages of labor as a constraining factor, the shortage of skilled labor and technicians has increased considerably. This has to be seen as a relative pricing phenomenon, especially as shortages of skilled labor have been registered quasi-permanently, even in the troughs of recessions. Steps have, therefore, been taken to stimulate the supply of skilled workers to industry. As to the potential changes in geographical and professional mobility, it might be that underlying mobility has declined. But empirical evidence for Sweden clearly shows that mobility is predominantly determined by the demand for labor.

As the staff notes, fiscal policies are quite restrictive in this phase of the upturn, in strong contrast to the procyclical demand management in previous upturns. According to my Swedish authorities, in 1984 the net demand impact of the public sector on the economy is calculated at an equivalent of minus 2.2 percent of GDP, compared with the positive impact of nearly 4 percent of GDP in 1979. As a result, the net financial deficit of the public sector has been reduced to 3.7 percent of GDP in 1984, a figure close to the average for OECD countries. As noted in the staff report, this reduction is explained both by the functioning of automatic stabilizers on the income side and by discretionary steps to curb the growth of public expenditure. It is especially important that the previous growth trend for public consumption, which was more than twice as rapid as GDP growth, has been broken. Present plans indicate medium-term growth in this sector well below potential GDP growth, thereby creating room for a relatively faster expansion of the competitive sector of the economy.

The Fund staff and my Swedish authorities agree upon the need for further active demand management in order to keep the economy on the present, successful course and, above all, to safeguard the established competitiveness through a further deceleration of inflation.

On the fiscal side, the medium-term survey, published this spring, recommended discretionary budget measures corresponding to a reduction of the deficit by 1 percent of GDP per year and in the coming three years. The survey is a civil service product, and the Government has not yet taken any official position on its recommendations. The Government has, however, already indicated the need for further steps in the fiscal field for 1985. The substance and extent of these measures will not be decided upon before the meeting with the social partners at the end of this summer. But my Swedish authorities agree that their efforts in incomes policies have to be supported by adequate demand management.

In the monetary field, the authorities will continue the policy--started in 1982--of maintaining strict control over the creation of liquidity from domestic sources. The aim is to avoid the possibility that excessive liquidity could have an inflationary effect on the domestic economy or, through stimulating outgoing capital flows, necessitate further government borrowing abroad. A starting point is, of course, the realized gradual reduction of the Government budget deficit. The new market-oriented borrowing instruments are then used to place government debt in the domestic market outside banks to a sufficient degree. If necessary, other measures will be applied to contain bank lending. Interest rates are adjusted to the operations in the domestic market, as well as to variations in international levels, to safeguard the balance of payments objective. The results up to now have been encouraging. The domestic contribution to money creation fell in the past 12 months to 5 percent, and M-3 growth fell to 3 percent (cf. Table 2 of the staff report).

When dealing with Sweden's performance in the field of trade and aid, the staff notes that the question of the establishment of foreign banks in Sweden is under study by a special commission. It might be added that under its terms of reference the commission has to study how--not whether--foreign banks should be allowed to establish themselves in Sweden. On this special issue, the commission in question is to report early this autumn.

Extending his statement, Mr. Lindå informed Directors that the preliminary consumer price index for mid-July had risen by 7.5 percent year-on-year, down from 8.1 percent in mid June.

Mr. Schneider noted that in the past year, Sweden had made impressive progress toward redressing the major economic imbalances. As a result of the two large devaluations of the krona and the pursuit of prudent policies, supported by the upswing in world economic activity, the authorities had succeeded in achieving a major turnaround in the external current account; in restoring external competitiveness, accompanied by a strong recovery in investment; in dampening the inflation rate; and in reducing the budget deficit to more manageable proportions, while maintaining a reasonable level of employment. At present, it appeared that the problems facing the authorities were more the result of overachievement of the recovery objectives. The major concern appeared to be how to deal with the tensions in the labor market resulting from the lack of skilled labor, and how to deal with the significant rise in profit margins in a number of sectors. Those factors could threaten the Government's objective of lowering the inflation rate, and their effect should not be underestimated. A sizable widening in profit margins was not a bad development per se, but in many cases such high profit margins encouraged entrepreneurs to be more amenable to wage demands, thereby endangering the objective of reducing inflation. Given the rapid increase in the profitability of the manufacturing sector in 1983, the ratio of wages to total income must have declined, providing another incentive for labor to press for wage increases. To deal effectively with that situation, and to reduce further the relatively high inflation rate, originally targeted at 4 percent in 1984, the authorities should, in addition to pursuing an appropriate incomes policy, further tighten monetary and fiscal policies. How realistic was the revised inflation forecast for 1984 of about 6 percent?

As for fiscal policy, the Swedish authorities had made impressive progress by reducing the budget deficit of the Central Government by 4.5 percentage points in terms of GDP between 1982/83 and 1984/85, Mr. Schneider said. The projected deficit of 8.5 percent of GDP in 1984/85 appeared high, but it should be noted that the social security system, which was in surplus, was not included in the central government budget. Nevertheless, the buoyancy of the Swedish economy indicated that there was sufficient room for a further reduction in the deficit. The authorities ought to achieve it primarily by reducing expenditures further in order to avoid an increase in the already high level of taxation.

As to the divergence of views between the Swedish authorities and the staff regarding the degree of strain on productive capacity, he had been impressed by the figures in the latest business survey provided by Mr. Lindå, Mr. Schneider remarked. Nevertheless, the fact remained that there was a need for further active demand management, as had been acknowledged by the Swedish Government.

He was in full agreement with the Swedish approach of pursuing an asymmetrical exchange rate policy, Mr. Schneider commented. In case of any upward pressure on the Swedish krona, timely movements in the exchange rate would moderate inflation and pressure on productive capacity.

Sweden provided one of the outstanding examples with respect to official development assistance (ODA), Mr. Schneider stated. The amount of ODA included in the budget was well in excess of the UN target, and it was commendable that about 85 percent of the assistance was untied and predominantly in the form of grants.

In sum, the authorities should be congratulated for the swift implementation of successful financial policies, which had led to an almost too rapid recovery in major areas, Mr. Schneider noted. He was confident that the newly emerging problems would be tackled by the authorities. A number of countries would not be unhappy to have Sweden's present problems. Contrary to the stabilization efforts of other countries, Sweden had succeeded in maintaining employment at an acceptable level, a remarkable achievement in the European context.

Mr. Joyce stated that he was in general agreement with the staff appraisal. The Swedish authorities had made rapid progress in correcting some of the major imbalances in their economy. At the time of the October 1982 devaluation of the krona, most Directors had emphasized that the authorities should support the devaluation with appropriate financial policies so that the gains in competitiveness accruing from the devaluation would not be lost through inflation. The increase in industrial profitability and competitiveness resulting from the devaluation had provided a good opportunity for the authorities to reduce industrial support measures and subsidies; they had made good progress in that direction and were to be congratulated.

However, he was concerned about the staff's view that the recovery had reached a point where strains were developing on productive capacity in certain sectors and that those strains were generating tensions in labor markets, Mr. Joyce went on. The Swedish authorities apparently had a somewhat different view. Could the staff or Mr. Lindå comment further on the differences of opinion, which, he believed, were not necessarily as far apart as they might seem at first glance? He assumed that there was agreement on both sides that some bottlenecks were developing, or were in danger of developing, in certain areas, such as the wood industries.

Neither the staff nor the authorities were indifferent to developments with respect to wages and prices, Mr. Joyce observed. He welcomed the termination of the wage freeze, as it would not have been effective for much longer. An incomes policy worked only when the underlying conditions were appropriate. When they were inappropriate or when the commitment to the policy was not universal, an incomes policy would succeed only for a short period.

Over the past 18 months, the authorities had followed a restrictive monetary policy, the efficiency of which had been enhanced by the introduction of new financial instruments, Mr. Joyce noted. He commended that action and urged the authorities to continue to maintain a tight monetary policy.

Fiscal policy had been important in restraining demand, Mr. Joyce went on. The significant reduction in the fiscal deficit was welcome. Overall, the recent evolution of the Swedish economy could be characterized as successful, although the success story had not yet been completed. It was encouraging to note the accomplishments of the authorities in the past year, but he was worried about the sustainability of recent improvements and about the effects of the devaluation. A number of Directors had expressed reservations about the size of the devaluation, and the staff had indicated that, in fact, the devaluation had perhaps been larger than might have been necessary. He realized that the authorities would not want to revalue the krona, but he hoped that they would not be lured into easing domestic policies by virtue of the fact that Sweden's competitive position had improved considerably as a result of the two sizable devaluations.

Mr. Grosche commended the Swedish authorities for their success in reducing internal and external imbalances during the past year. However, despite that success, Sweden still had some way to go to consolidate the basis for sustainable, noninflationary growth. On the positive side, financial policies had been tightened; the current account, aided by a strong trade balance, had approached equilibrium; and the profitability of enterprises had been restored. On the negative side, the rate of inflation and the public sector deficit remained high, the inflation differential vis-à-vis Sweden's major trading partners was still large, and the most recent wage settlements seemed to endanger further progress toward adjustment.

On fiscal policy, although the public sector deficit had been reduced substantially, it remained high and was probably incompatible with the announced targets of economic policy, Mr. Grosche stated. The reduction in the deficit by 2 percentage points of GDP in 1984/85 would help to counter the potential dangerous developments on the wage and price fronts. A further reduction would require major discretionary efforts, particularly on the expenditure side, as total public expenditure accounted for about two thirds of GDP. He agreed with the staff that the authorities should consider making cuts in transfer payments and should reduce the automatic indexation of various outlays. He encouraged them to specify as soon as possible their fiscal policy targets beyond 1984/85 in order to reassure the private sector. Additionally, cuts in expenditure would enhance the scope for reforms on the revenue side, including improved incentives in the tax system.

He welcomed the restrictive stance of monetary policy, as evidenced by the low growth rate of monetary aggregates, Mr. Grosche went on. The announcement of a target range for the growth of M-3 should enhance the role of monetary policy in stabilizing the economy, because public confidence in the authorities' willingness to act appropriately would be strengthened. The recent increase in domestic interest rates should help the authorities to attain the announced objectives. He shared the staff's view, however, that it might prove necessary to take further action, either because inflation might not decline sufficiently or because increasing international interest rates might induce capital outflows. The staff had conveyed the impression that the conduct of monetary policy might be impaired by the highly liquid public debt instruments recently issued by the Government. Could the staff comment on that possible impairment?

He welcomed the measures taken to deregulate and strengthen the financial markets, Mr. Grosche said. However, he doubted that the remaining direct controls on banks and credit institutions were of such vital importance that further liberalization would endanger other policy objectives. The allocative efficiency of any economy was best served when regulations and controls were kept to a minimum.

On wages, the strong decrease in the growth rate of unit labor costs over the past two years had restored industrial profitability and revived investment, Mr. Grosche observed. In contrast, some wage agreements reached in early 1984, ranging between 7 percent and 10 percent, were hardly compatible with the target of reducing inflation to about 4 percent. If those wage increases indicated the general trend in wage movements in 1984, further progress toward sustainable, noninflationary growth and external equilibrium would be seriously impaired. Therefore, he welcomed the authorities' intention to tighten financial policies if wage settlements turned out to be incompatible with the inflation target. The decentralized framework in which wage negotiations were taking place was appropriate; he hoped that that approach would permit a high degree of wage differentiation, which, over time, might increase labor mobility and the supply of skilled labor.

Finally, on the external side, the large devaluation of the krona in 1982, the strong recovery in world trade, and the rise in prices for some of Sweden's export commodities had contributed to the strong improvement in the trade balance, Mr. Grosche commented. He welcomed the authorities' use of Sweden's strong competitive edge to curtail subsidies to industries. The remarkable improvement in the current account could be sustained only if wage increases remained small and if the public sector budget deficit were reduced further. He agreed with the staff that upward pressures on the exchange rate should be reflected in an appreciation of the krona, rather than offset by a relaxation of financial policies.

Mr. Clark observed that since October 1982 the authorities' strategy had aimed at stimulating exports and investment, while reducing inflation. Exports had increased strongly and were still doing well; investment was rising after several years of stagnation. However, the October 1982 devaluation, in combination with the large public sector deficit, might have given too strong a stimulus to the economy, as evidenced by price and wage developments generally.

Although inflation was declining, consumer prices had risen by 8.1 percent in the year ended June 1984, Mr. Clark noted. The authorities should pursue determined fiscal, monetary, and wage policies to avoid a resurgence of inflation, which could undermine the recovery.

The deficit of the Central Government had been declining, although it remained large at about 10 percent of GDP, Mr. Clark went on. The authorities were to be commended for the steps taken to reduce the overall deficit by 1.2 percent of GDP in 1983. The further reduction of 1.9 percent of GDP planned for 1984 was welcome. That objective would not be easy to achieve, because it was likely to involve changes in the system of social transfers, which, the staff had suggested, needed to be adjusted sooner rather than later. He agreed with the staff that a further sharp reduction in the fiscal deficit was essential if both low unemployment and low inflation were to be achieved and sustained.

The persistence of sizable fiscal deficits had complicated the task of monetary control, Mr. Clark remarked. He therefore welcomed the introduction of new borrowing instruments, which had facilitated a sharp increase in the nonbank financing of the budget deficit. By end-May 1984, treasury notes and discount notes held outside banks had amounted to 19 percent of the money stock. Did the staff expect that form of financing to grow further? Could the staff or Mr. Lindå indicate whether the authorities were aiming at a particular target mix of financing? The introduction of those borrowing instruments had reinforced the trend toward greater interest rate flexibility. He welcomed the recent decision by the authorities to raise interest rates: such action represented a move away from quantitative credit ceilings as a means of monetary control and might encourage higher savings by the household sector.

The authorities' intention to contain inflationary expectations by securing low wage increases during 1984 and 1985 was commendable, Mr. Clark continued. However, the announced targets, even if achieved, could be undermined by wage drift. Like the staff, he hoped that the authorities would refrain from excessive reliance on incomes policy. While the recently introduced wage earners' funds might be of short-term benefit in the negotiating process, they could have a longer-term negative impact on industrial competitiveness and profitability. If the negotiations with the social partners did not meet the authorities' target, he hoped that firm compensatory measures would be introduced. Mr. Lindå argued that the pressure for wage increases in Sweden might be a response not so much to high profitability as to shortages of skilled labor. Could the staff or Mr. Lindå indicate how far the government employment scheme, currently involving 3.7 percent of the labor force, was likely to provide workers with the skills required by Swedish industry? Was there any indication that the trade unions would accept significant wage differentials, which might help to relieve the shortage of skilled labor in a more fundamental way?

As for industrial policy, the authorities were to be commended for the substantial reduction of industrial subsidies between 1983 and 1984, Mr. Clark said. He welcomed the statement by Mr. Lindå that a special commission on the establishment of foreign banks in Sweden was to report to the Government in the third quarter of 1984. Did the authorities have any plans for early action on the proposed liberalization of the insurance sector?

Mr. Templeman recalled that at EBM/83/128 (9/2/83) his chair, and Directors in general, had expressed some concern about the adequacy of the Swedish authorities' domestic demand management policies in support of the devaluation of the krona. He was pleased to note that those policies had been strengthened during the past year. For example, the ratio of the public sector and central government deficits to GDP had been reduced, as had monetary financing of the deficit, with the help of the introduction of nonbank financial instruments. Monetary growth had decelerated somewhat, and the domestically generated component had been reduced. However, the rate of inflation remained comparatively high by industrial-country standards, and the recent resurgence of wage pressures demonstrated the need for continued demand restraint. The exchange rate and interest rates were two policy instruments that had not been used very actively to resist inflationary pressures. It would be consistent with the Government's anti-inflation efforts and with some moderation of capital outflows to allow any further upward pressures on the krona to take effect and to permit upward movements of interest rates, such as the recent discount rate increases.

In terms of economic performance, the authorities had had quite impressive success in several areas, Mr. Templeman observed. The move from a deficit in the current account of the balance of payments to a possible surplus in 1984, mainly as a result of strong export growth and increases in Sweden's market share, was especially impressive. The rise in business investment was also encouraging and, indeed, necessary for sustained growth. Perhaps more important in the long run was the initial success achieved in tackling some of the basic problems of the industrial sector. Given the persistent structural adjustment problems in industry in other developed countries, the authorities' progress in wage restraint, profitability, industrial production, and employment were particularly welcome. How would the staff evaluate the effects of the wage earners' fund on the investment climate?

Despite recent favorable developments, the progress achieved to date in Sweden offered little margin for error in domestic demand management policy, and some important longer-term structural reforms were necessary, Mr. Templeman continued. With respect to fiscal policy, he welcomed the recent reform of the income tax system to reduce high marginal tax rates. Moreover, with public sector revenues amounting to more than 62 percent of GDP, there was little, if any, opportunity for reducing the public sector deficit further through revenue action. Discretionary expenditure cuts, together with reduced automatic indexation of expenditures and transfers, seemed to offer the greatest potential for further deficit reduction. The tying of some indexed expenditure to the target rate of inflation, rather than the actual rate, could prove helpful in gradually reducing automatic indexation. The continued reduction in industrial subsidies should be encouraged.

As to monetary policy, Mr. Templeman inquired whether there was room for further financial innovations. The planned opening up of the economy to foreign banks was welcome. He encouraged the authorities to allow market forces to have more of an impact on credit allocation. The authorities' incomes policy, including the recent agreement on a 5 percent limit on average wage increases in 1985, would contribute to the anti-inflation effort, although he agreed with the staff's cautionary note about the risk of depending too much on incomes policy.

Finally, reforms in the labor market, together with better inflationary performance, were the key to a sustainable economic recovery, Mr. Templeman commented. Although the staff and the Swedish authorities did not entirely agree on the extent of the strain on existing capacity, they agreed that the shortage of skilled labor was a problem. Could the staff comment further on those issues? Greater wage differentiation, labor mobility, and training were necessary. Furthermore, the shortage of skilled labor raised questions about the generosity of unemployment benefits. What accounted for the rise in employment in the public sector? Did public sector employment affect labor availability in the private sector? What was the outlook for public sector employment? Sweden's labor market problems were common to a number of industrial countries, and he hoped that the authorities could set the pace for reducing chronic growth and employment problems.

Mr. Nguyen observed that since the second half of the 1970s, economic performance in Sweden had been less than satisfactory. Industrial production had slackened, and real GDP growth had deteriorated markedly. The budget and the balance of payments had been characterized by large deficits, and external debt had increased rapidly. However, unemployment had remained low by international standards. Against that background, appropriate corrective measures had been implemented in the wake of the two devaluations of the krona. He commended the authorities for the success of their policies, particularly with respect to the current account balance, output, and external competitiveness.

The authorities had also carried out some structural adjustment, Mr. Nguyen remarked. Subsidies to ailing industries had been reduced dramatically, and more flexibility had been introduced in the labor and financial markets. Despite that progress, there were some dark spots in the economy: investment remained depressed, consumer price increases were high, and the fiscal deficit was still large. He shared the staff's concern about the sustainability of the recent improvement. The Swedish authorities seemed to have recognized the need for supportive financial policies, but they might have to tighten some of those policies further.

Demand management policies had generally been firm, Mr. Nguyen stated. Given the size of the budget deficit and the strong link observed in the past between the public sector deficit and the current account deficit, the decision to curb the growth of public expenditures in 1984/85 was welcome. However, the expected reduction of the deficit would be brought about primarily by an estimated average increase in revenues of 10.3 percent, including a 34 percent increase in income and capital taxes. It could be argued that, given the already high rates of taxation, tax increases could have an adverse impact on productivity and capital formation. Continued efforts to reduce the budget deficit had been accompanied by a restrictive monetary policy, with a sharp deceleration in money and credit expansion. The introduction of new instruments, especially treasury discount notes, had improved the efficiency of the market, but more could be done to eliminate rigidities in the financial sector.

Wage policy was of critical importance to attaining the inflation and balance of payments objectives, Mr. Nguyen continued, and it was crucial that the aim of limiting wage increases to 5 percent in 1985 be achieved. However, given the significant real wage losses in recent years and increased profitability, pressure for wage increases might be great. Despite the differences in opinion between the staff and the authorities on the causes of renewed inflationary pressures, it could be concluded that, even in a period of high unemployment, demand for skilled labor and higher wages eventually had an inflationary effect, even in the less dynamic sectors. Therefore, increased labor mobility and wage differentiation to attract workers and new investments were among the best ways to avoid inflation.

The staff had questioned whether an exchange rate adjustment was an effective way to influence wage developments, Mr. Nguyen observed. As the present exchange rate appeared to be overcompetitive, an exchange rate adjustment would be appropriate. At EBM/82/166 (12/22/82), the staff had judged that an adjustment of 10 percent, well above what had been required by changes in unit labor costs, would have been quite sufficient. At that time, his chair had stated that overextending the amount of depreciation would not help to influence wage developments. He agreed with the staff conclusion concerning the benefits of an appreciation of the krona in terms of lower inflation and reduced pressures on productive capacity.

Given the openness of the economy and its small size, trade was an important element in economic growth, Mr. Nguyen observed. The Swedish authorities' commitment not to resort to new protectionist measures during the recession was therefore commendable. Furthermore, their commitment with respect to official development assistance was exemplary. About one third of Sweden's ODA, which represented 1 percent of GDP, was channeled through international organizations. Finally, progress during the past 18 months had been impressive, and the present recovery had only to be consolidated. He admired the "Swedish model," which was still a reference point in the field of work relationships and welfare.

Mr. de Vries remarked that the Swedish economy was characterized by favorable short-term developments and by the persistence of structural problems that required further adjustment efforts. Some of the problems facing Sweden were similar to those confronting the Netherlands. Both economies had a high proportion of GDP passing through the public sector. He was surprised to note some discrepancies with respect to public sector expenditure between Table 17 of SM/84/179 and Table 1 of SM/84/167; could the staff explain? The data in SM/84/179 indicated that in recent years about 70 percent of GDP had passed through the hands of the Government.

Indeed, many of the structural problems in Sweden arose from the high share of GDP passing through the public sector, a fact that had perhaps not been adequately recognized by the authorities, Mr. de Vries stated. The Civil Service Commission had recommended that the deficit should be reduced by 1 percent each year for three years, but it had failed to indicate the method by which that reduction should be brought about. A reduction in the budget deficit through an increase in revenues would not help the economy. Taxes were the problem, rather than the solution. The authorities should set a medium-term goal for government expenditure, and should perhaps use revenue policies for purposes of demand management. On the one hand, the tax burden had been increasing in recent years and could not continue to do so. On the other hand, government expenditure could not be reduced rapidly. The authorities faced a structural problem that deserved serious attention.

Sweden's short-term economic success was due to the two devaluations of the krona, the accompanying wage moderation, and the reduction of subsidies to industry, Mr. de Vries observed. He agreed with other Directors who had pointed out that the success of incomes policy could be sustained only if demand management were restrained and demand pressures contained. The authorities should reduce subsidies further, because the rising profits in industries might lead to additional pressure on wages. The need for some reduction in aggregate demand was indicated by the high inflation rate, which had stabilized at about 8 percent.

Although the authorities were pursuing a more appropriate monetary policy, it remained largely ineffective owing to a number of structural factors, including the monetization of the large government debt, Mr. de Vries commented. Domestic interest rates should be aligned more appropriately with international interest rates.

In retrospect, the exchange rate adjustment had been on the large side, Mr. de Vries stated, but the impact of that adjustment on other countries had been lessened by the reduction in subsidies in Sweden. No case could be made for reversing the exchange rate adjustment, particularly given the inflation differential between Sweden and many of its neighbors. Finally, the Swedish authorities had shown great regard for their international responsibilities, particularly by contributing to development aid and maintaining an open trading system.

Mr. Coumbis remarked that since 1982 the Swedish economy had been on the right track. Two devaluations in 1981 and 1982 and appropriate demand policies, applied consistently and with determination since that time, had improved the competitiveness of Swedish industry substantially and had resulted in an improvement in the external current account. However, there were some clouds on the economic horizon: foreign debt was approaching 34 percent of GDP; inflation was still high; there were indications that the working population was unwilling to accept further reductions in real wages. He was in agreement with the thrust of the staff appraisal.

In some areas, there were differences of opinion between the staff and the authorities, Mr. Coumbis indicated. First, on the degree of strain in the productive capacity of the economy, could the staff comment on the latest business survey published in Sweden in July? Second, the authorities believed that a revaluation of the krona could be considered if both the balance of payments position and the competitiveness of Swedish industry proved durable. They considered that the current account had only just reached equilibrium, despite favorable competitiveness and high foreign demand. However, according to the staff, given the strength of the current account and the benefits of an appreciation of the exchange rate in terms of lower inflation and reduced pressures on productive capacity, it would be desirable to allow pressures in the exchange market to be reflected in the exchange rate. He shared the staff's view; that prices so far had declined only slightly from the 1982 level, while the current account deficit had disappeared, indicated that inflation was the major problem for the Swedish economy.

Third, with respect to the timing of the introduction of new measures to reduce the public sector deficit further, Mr. Coumbis went on, the staff believed that the likelihood of a stronger than expected foreign trade performance and investment recovery, and the danger signs on the wage and price front, called for further tightening of demand policies in 1984 and 1985. The authorities, however, indicated that further measures to reduce the public sector deficit would be applied only if the social partners did not moderate their demands for wage and price increases.

The rate of inflation for 1983 and the first four months of 1984 was about the same as in 1982, Mr. Coumbis said. The rate of inflation for 1984 was not expected to be less than 6 percent, as against a target of 4 percent. In order for the authorities to reduce the present rate of inflation to the 3 percent target in 1985, they should reduce the public sector deficit and expenditures further in 1984 and 1985. Finally, he congratulated the authorities for their skillful management of the economy.

Mr. Teijeiro observed that developments in the Swedish economy were satisfactory. The turnaround in economic indicators was impressive; it was particularly remarkable that the devaluation of 1982 had improved the relative prices of the traded goods sector, thus increasing profitability in manufacturing, and also improved the growth prospects of the economy, without jeopardizing the inflationary objective. The restrictive fiscal stance was a major element explaining those simultaneous achievements. A reduction of the deficit by 3.3 percent of GDP in two years was significant, particularly when a major part of that reduction had taken place on the expenditure side.

A successful incomes policy had been another major element helping to explain Sweden's success in keeping inflation down after the devaluation of the krona, Mr. Teijeiro continued. It was encouraging that the authorities were making progress toward reaching agreement with the unions on limiting wage increases to 5 percent in 1985, but he agreed with the staff that appropriate financial policies were necessary to contain inflationary pressures and that excessive reliance on incomes policy should be avoided. Efforts to reduce the fiscal deficit further should be maintained, and restraint on government expenditure should help to check inflation and wage developments. Mounting pressure in the labor market was a major risk. Government employment, in particular, had been growing during recent years at rates much higher than total employment. The authorities should adopt a more stringent employment policy in the government sector.

Progress had been made in monetary policy, Mr. Teijeiro continued. However, he was concerned about the present stance; no targets for monetary growth had been established, and domestic interest rates remained significantly lower than international rates. Consequently, private capital flows continued to be negative. Further progress should be made in that area. The significance of the deceleration in the rate of growth of M-3 was difficult to determine, as the recently introduced highly liquid public debt instruments might have reduced the demand for assets included in the definition of M-3. In any event, there was a need for higher interest rates and slower credit expansion.

On the external side, Mr. Teijeiro went on, the current account of the balance of payments had improved in 1984 and might improve further in 1985. The staff and the authorities had a difference of opinion about the appropriate exchange rate policy should a current account surplus emerge. The authorities had indicated their aim of achieving a surplus in the current account in order to reduce external indebtedness. The staff had recommended that the authorities should allow any upward pressure that might develop on the exchange rate to be reflected in an appreciation of the currency, thereby helping to diminish current pressures on prices and productive capacity rather than offset by a relaxation of monetary policy. However, neither currency appreciation nor monetary relaxation was the only course of action possible. For instance, the Swedish authorities could run a current account surplus, without jeopardizing monetary policy, if they changed the mix of deficit financing, by repaying external debt and increasing their domestic borrowing. In that way, monetary policy would not be jeopardized. In fact, the authorities had taken a symmetrical approach in the late 1970s and early 1980s, when a current account deficit had been accompanied by increased foreign financing of the public sector.

The argument against the maintenance of a rigid exchange rate policy was based on the damaging effects of fixed relative prices, which did not reflect market trends, Mr. Teijeiro said. In fact, Swedish macroeconomic policies had generally tended to fix most relative prices. The argument in favor of maintaining the present exchange rate policy was that it might allow Sweden to repay foreign debt while real interest rates were high. From the point of view of Fund surveillance, it was worth noting that previous policies pursued by the authorities had put pressure on world capital markets, as a consequence of official action. Should the Fund advise Sweden to follow an asymmetric exchange rate policy now that it was necessary to repay the foreign debt that had been artificially encouraged? There were merits in both positions: market forces should be allowed to determine relative prices in Sweden, but the country should not be discouraged from repaying part of its foreign debt. Those positions could be reconciled. For example, the pursuit of a more flexible exchange rate policy, aimed at a particular rate of repayment of public external debt, could be the appropriate stance.

The authorities should be praised for their free trade policy, Mr. Teijeiro considered. Sweden had not introduced any new trade restrictions during the past recession and had endorsed a proposal for a new round of GATT discussions on lowering import barriers worldwide, particularly to trade in agricultural products. The authorities were also committed to providing a high level of foreign aid.

Mr. Suraisry indicated his general agreement with the staff analysis. The Swedish authorities had made remarkable progress in tackling the underlying imbalances in the economy over the past 18 months. The recovery was well established; industrial profit margins had been restored; unemployment was beginning to fall; the external accounts had moved into surplus. The outlook for 1985 was more encouraging than it had been for some time past.

Those impressive achievements had reversed the steady deterioration in economic performance since the mid-1970s, Mr. Suraisry observed. That success was due primarily to the authorities' determined pursuit of a clear, medium-term strategy, based on sound financial policies and structural change. The central question was whether the recovery could be sustained. He believed that it could be, provided that the authorities continued with the same mix of policies that had worked so well in recent months.

The main obstacle to a lasting recovery was the persistence of inflationary pressures, which could be traced, in part, to strains on productive capacity and, in part, to wage settlements well above the Government's inflation targets, Mr. Suraisry commented. He therefore welcomed the agreement between the Government and trade unions to limit the increase in average earnings to 5 percent in 1985. It was unclear whether wage increases would remain within that limit. The Ministry of Finance had called for a new system of wage determination in order to realize the objectives of full employment and low inflation in the medium term. Could the staff or Mr. Lindø comment further on those important issues?

As the authorities recognized, wage restraint had to be supported by firm financial policies, Mr. Suraisry continued. Progress had already been made in reducing the budget deficit, and the stance of fiscal policy for 1984/85 was appropriately cautious. He agreed with the staff that further efforts to reduce expenditure would be necessary in 1985 and beyond, in order to bring inflation down and promote a balanced recovery.

He supported the shift since late 1982 to a more restrictive monetary policy, Mr. Suraisry said. He hoped that the authorities would continue to finance an increasing share of the budget deficit by nonmonetary means. The introduction of new debt instruments had contributed to a marked slowdown in the growth of bank credit and broad money, and had helped to make the financial system more open, flexible, and efficient.

On the external side, Swedish exporters had taken full advantage of their improved competitive position after the 1982 devaluation and were well placed to benefit further from the world recovery, Mr. Suraisry remarked. A sustained improvement in the current account was clearly essential if the authorities were to reduce the debt service burden to more comfortable levels.

In the longer term, he fully supported the authorities' efforts to streamline the industrial sector, reduce subsidies to ailing industries, and increase the supply of skilled workers, Mr. Suraisry indicated. The swift turnaround in the trade account showed that forward-looking structural adjustment of that kind could produce significant benefits. Finally, he commended the authorities for maintaining an open trade system and for their plans to open the banking and insurance sectors to foreign competition. Their record in providing ODA was commendable, and he hoped that other industrial countries would follow Sweden's example.

Mr. Malhotra noted that the Swedish economy had improved markedly over the past 18 months as a result of the successful financial policies pursued by the authorities. The recovery appeared to be well established. The rate of unemployment was substantially lower than in other European countries. External competitiveness had been restored, and the manufacturing sector was profitable.

The overall fiscal deficit had been reduced over the past two years, but it should be reduced further, mainly through expenditure reduction, Mr. Malhotra said. Monetary policy had been generally restrained, although the considerable liquidity in the economy would have to be tackled. The Government was increasingly resorting to nonbank financing, and interest rates had moved in the right direction. The authorities must continue to aim at reducing inflationary pressures; inflation continued to be high relative to other industrial countries. Sooner or later, strains on productive capacity would appear. While the incomes policy was appropriate, he agreed with the staff that it was the overall stance of fiscal policy that would ultimately determine the success of income and wage policies. It was important to narrow the overall fiscal deficit and to reduce inflation still further. In conclusion, he appreciated Sweden's official development assistance record, which was one of the finest. It had continued to provide assistance at a time when the Swedish economy had been facing major problems. The quality of aid had also been commendable.

Mr. Salehkhou welcomed the inclusion in the staff paper of the summary of the main conclusions of the Executive Board's discussion at EBM/83/128 (9/2/83), on the 1983 Article IV consultation with Sweden. He encouraged the staff to continue that practice and to expand the coverage to include Directors' comments on those areas that needed greater attention or policy changes.

The so-called overheating of the industrial and foreign trade sectors in Sweden was a welcome change from the situation in other countries, whose industries were unprofitable and inefficient, Mr. Salehkhou remarked. The main stimulus for increased production came from exports, as consumption and investment had declined in 1983. Mr. Lindå had rightly pointed out that demand was the most important factor influencing the decisions of entrepreneurs in the manufacturing sector. The increase in demand had come mainly from Sweden's export markets. It might therefore be too early to conclude that the increase in production might lead to excessive capacity utilization and, hence, to renewed inflationary signals. The authorities seemed aware of the potential repercussions of excess overheating and were prepared to take appropriately firm demand management measures should the need arise.

As for exchange rate policy, following the two devaluations in 1981 and 1982, the real effective rate of the krona had remained more or less steady, Mr. Salehkhou observed. However, with respect to the base year of 1978, the krona had depreciated considerably by March 1984 relative to the currencies of other industrial countries. The staff advised the authorities to let the krona appreciate, should upward pressures develop on the exchange rate. Could Mr. Lindå comment on the authorities' asymmetrical exchange rate policy? There had been considerable capital outflows during 1983 and thus far in 1984. In view of Sweden's appreciable accumulation of foreign debt, he wondered about the possible impact of a potential exchange rate revaluation on trade, competitiveness, and, hence, on the generation of a current account surplus to be used for debt servicing. Did the authorities share the staff's view that, notwithstanding the recent domestic measures, sustained upward pressures on the exchange rate would soon develop, and that they should not be suppressed through deliberate intervention? He was confused by the staff's assertion that the competitiveness and profitability of industry had been fully restored. Did the staff believe that there was no room for further improvement and that the exchange rate adjustments, apparently responsible for the external turnaround, might cause a deterioration in the external position if the exchange rate were to be readjusted? If upward pressures did require a revaluation of the exchange rate, what other supportive domestic policies would be called for?

The Government had responded to the improvement of the external sector by introducing a package of measures, including an incomes policy, and more restrictive monetary and fiscal policies, Mr. Salehkhou commented. The growth of broad money had declined considerably from its peak in 1982. Fiscal policy had been designed to reduce inflation; a further cut of 2 percent in current expenditure was included in the 1984/85 budget, in an effort to reduce the deficit. Those measures had resulted in a stable, moderate rate of inflation in 1983 and 1984. Given that the consumption and investment components of domestic demand were already relatively low, could the staff explain its suggestion that expenditure should be reduced further? That suggestion was even more questionable in view of the fact that GDP growth rate in 1983 had not been large by recent standards of industrial countries.

His authorities appreciated the generous and humanitarian foreign aid policy of Sweden, Mr. Salehkhou stated. Its exemplary aid record had put Sweden at the top of the aid donors' list and had generated feelings of goodwill and appreciation throughout the world, especially among the very poor countries totally dependent on foreign grants. He hoped that other more affluent countries would follow Sweden's example. Finally, he agreed with the general thrust of the staff appraisal.

Mr. Senior commended the Swedish authorities for their success in checking the country's drift toward economic stagnation and external imbalance. In the recent past, economic management in Sweden had aimed to correct the monetary imbalances of the past decade. As a result of continuous fiscal and monetary restraint, together with appropriate exchange rate and wage levels, there had been a remarkable turnaround in the balance of payments position. That turnaround had been due largely to the lag effects of the gains in competitiveness achieved as a result of the 1982 devaluation of the krona. However, the cautious stance of fiscal and monetary policies had also played a positive role in the outcome of the external accounts. The improvements in the external position had been accompanied by greater economic growth and a relatively stable inflation rate, indicating that the economy's competitiveness was appropriate.

There seemed to be differing views between the authorities and the staff on the prospects for sustaining the recent recovery, Mr. Senior observed. According to Mr. Lindå, the Swedish authorities considered that the threats to the current recovery stemmed not from labor supply factors, but from the depressed state of aggregate demand. The staff, however, argued that the escalation of wage claims was an indication of pressure on productive capacity and tension in the labor market induced by an excessive stimulation of demand. The question whether current demand management policy was too expansionist could not be settled conclusively unless further information were available on the state of business confidence and the strength and nature of inflationary expectations, whether they had significantly abated or were being ignited by current policies. If wage earners and entrepreneurs expected that inflation would not fall below the 8.5 percent experienced over the past year, any expansion of nominal demand might increase inflationary expectations rather than output. It was difficult to ascertain whether there was room for a noninflationary expansion of demand. The recently ended price freeze had undoubtedly obscured the extent of inflationary expectations and the public's view of the Government's adjustment policies; therefore, the outcome of negotiations between unions and employers was not a reliable basis for calibrating inflationary expectations. Incomes policies frequently gave the wrong impression of the strength of inflationary forces because wage earners could demand concessions in the form of reduced working hours or lower productivity, rather than increased nominal wages.

On the whole, he tended to agree with the staff that it would be appropriate for the authorities to be cautious at the present stage of the recovery, Mr. Senior stated. If incomes policy were not accompanied by sound monetary and fiscal policies, inflation, fueled by frustrated expectations, might accelerate faster than it would in the absence of an incomes policy. In that case, it would be difficult and painful to reduce inflationary expectations. The authorities were well advised to refrain from injecting additional stimuli into the economy, as the associated risks might prove too difficult a burden. In sum, the staff's comments regarding demand management policies were appropriate, and he was sure that the authorities stood ready to correct their policies, should it become necessary. The success achieved thus far through economic management bore witness to the flexibility and readiness of the authorities to implement appropriate measures to reach their objectives.

Mr. Hassan indicated his broad agreement with the staff appraisal. The Swedish authorities were to be commended for the rapid progress made in reducing the domestic and external imbalances. The current account position had improved remarkably, and profitability of industry had been restored, resulting in higher output and employment. However, further progress was called for in some areas. In particular, efforts should be directed toward reducing the fiscal deficit further, and developments on the inflation front needed special attention. Finally, he commended the authorities for the high level of official development aid.

The Executive Directors agreed to resume their discussion in the afternoon.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/84/121 (8/3/84) and EBM/84/122 (8/6/84).

3. IVORY COAST - STAND-BY ARRANGEMENT - EFFECTIVE DATE

1. The Fund notes the arrangements made with respect to the financing of the uncovered gap in Ivory Coast's balance of payments for 1984 and the fiscal measures described in EBS/84/81, Supplement 3, and finds that the arrangements are satisfactory.

2. Accordingly, the stand-by arrangement for Ivory Coast in EBS/84/81, Supplement 2, shall enter into effect on Friday, August 3, 1984.

Decision No. 7778-(84/122), adopted
August 3, 1984

APPROVED: May 21, 1985

JOSEPH W. LANG, JR.
Acting Secretary