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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/188

10:00 a.m., December 21, 1984

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	N. Toé, Temporary
	M. K. Bush
	L. E. J. M. Coene, Temporary
B. de Maulde	X. Blandin
	M. Z. M. Qureshi, Temporary
H. Fujino	M. Sugita
	B. Goos
	D. Hammann, Temporary
J. E. Ismael	
	G. W. K. Pickering, Temporary
A. Kafka	C. Robalino
	A. S. Jayawardena
	A. Vasudevan, Temporary
	A. Abdallah
	J. A. K. Munthali, Temporary
	B. Jensen
	E. M. Taha, Temporary
	E. M. Ainley, Temporary
P. Pérez	
J. J. Polak	T. de Vries
	A. V. Romuáldez
	R. Msadek, Temporary
J. Tvedt	
N. Wicks	
S. Zecchini	N. Coumbis
	Chen J., Temporary

L. Van Houtven, Secretary
S. L. Yeager, Assistant

Also Present

R. Manning, Alternate Executive Director, IBRD. European Department: L. A. Whittome, Counsellor and Director; B. Rose, Deputy Director; A. Fidjestol, W. L. Hemphill, H.-J. Huss, A. Knöbl, M. Mentini, S. Mitra. Exchange and Trade Relations Department: M. Guitián, Deputy Director; R. K Abrams, D. A. Lipton. Fiscal Affairs Department: G. Blöndal, P. Kohnert, A. B. Petersen. Legal Department: Ph. Lachman, A. O. Liuksila, J. M. Ogoola. Western Hemsiphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; C. Atkinson, O. Gronlie, J. Jaramillo-Vallejo, C. G. Muñiz B., J. F. van Houten. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: G. R. Castellanos, H.-S. Lee, G. E. L. Nguyen, M. A. Weitz. Assistants to Executive Directors: J. de la Herrán, J. J. Dreizzen, A. K. Juusela, H. Kobayashi, M. Lundsager, K. Murakami, E. Olsen, C. A. Salinas, A. H. van Ee, Wang C.-Y., A. Wood.

1. ARGENTINA - REPORT BY DEPUTY MANAGING DIRECTOR

The Deputy Managing Director informed Executive Directors that during the previous week he had participated in several of a series of meetings held in the United States and abroad at which the Argentine authorities and the coordinating commercial banks had submitted the financial package for Argentina to various larger groups of commercial banks. The Managing Director had participated in one meeting held in New York, and the Director of the Western Hemisphere Department had attended another meeting in Canada. The purpose of Fund participation had been to give the Fund's view of Argentina's economic program and the financing package. Most of the questions that had arisen had been technical, and had related to the nature of the commercial banks' contribution to the financing package, particularly its impact on their portfolios. Following the meetings, efforts had been made by the Argentine authorities and the coordinating banks to accelerate the decisions of individual banks in order to obtain the critical mass of financing that had to be committed before the Executive Board could consider Argentina's request for a stand-by arrangement. If Executive Directors learned from their authorities of any questions on the part of banks, in the course of their deliberations on the financing package, he himself would be glad to inform the coordinating banks or the Argentine authorities in order to expedite the attainment of the critical mass.

The Chairman indicated that he would keep Executive Directors informed of the progress made in assembling the needed critical mass; he continued to expect that Argentina's request for a stand-by arrangement would be considered by the Board as scheduled on December 28.

2. NORWAY - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with Norway (SM/84/266, 12/3/84). They also had before them a report on recent economic developments in Norway (SM/84/267, 12/7/84).

Mr. Tvedt made the following statement:

> The Norwegian authorities are in broad agreement with the staff's analysis. Since the 1984 Article IV consultation discussions in October, some new information on the Norwegian as well as the international economy has become available. The new statistical data and revised forecasts show a somewhat more optimistic outlook than was the case early this autumn. Thus, the underlying growth in the Norwegian economy appears to be stronger than previously assumed. The growth in domestic demand is now estimated at about 3 percent in 1985, compared with the previous forecast of 2 3/4 percent. The estimate for the GDP growth for "mainland" Norway has been revised upward to 2 1/2 percent, the same rate of growth as in 1984. One especially favorable feature is that fixed capital investments by the business sector--apart

from shipping, the oil sector, and housing--are estimated to increase by as much as 9 percent in volume terms in 1985. Manufacturing investments, which have declined for several years, are expected to show a volume growth of 10 percent in 1984, and growth is forecast at 20 percent in 1985. Because of a decline in investments in the oil sector, total GDP growth, including the oil and shipping sectors, is expected to be only 1 1/4 percent in 1985, compared with 4 percent in 1984.

The labor market has shown a clear improvement in the course of 1984, and by November the seasonally adjusted unemployment rate had declined to about 3 percent. A further reduction in unemployment is expected in 1985.

The rise in prices is continuing to abate. In the 12 months to November 1984, the consumer price index rose by 6 percent, and the Government expects that, on average, consumer prices will be 5 3/4 percent higher in 1985 than in 1984, compared with a 6 1/4 percent increase from 1983 to 1984. However, the rate of price rises is still stronger in Norway than in its main trading partners.

The price and cost problems in the Norwegian economy are therefore still substantial. The wage rise in manufacturing now appears to be 7 percent in 1984, or about 1 percentage point more than supposed during the wage negotiations last spring. Nevertheless, unit labor costs in manufacturing have not risen more in Norway than in competitor countries, owing to the exchange rate adjustments last summer and autumn. Given unchanged exchange rates, some improvement in competitiveness (0.5 percent to 1 percent) should be possible in 1985.

Because of more buoyant domestic demand, the volume growth of traditional imports is estimated to be somewhat higher in 1984 and 1985 than indicated in the staff report. At the same time, an upward adjustment has been made in the estimate for the rise in import prices in 1985. For traditional exports, the estimates presented in the staff report remain unchanged, while the oil sector's contribution to the balance of payments has been revised slightly downward. As a result of these developments, the estimate for the current account surplus has been revised downward to about NKr 25 billion in 1984 and to barely NKr 16.5 billion in 1985.

The approved government budget for 1985, including the National Insurance Scheme, shows a surplus before loan transactions of about NKr 4.9 billion, or about 1 percent of GDP, compared with 3.7 percent of GDP in 1984. However, when oil taxes, transfers from Norges Bank, and net income from state petroleum activities--revenues that have limited effects on domestic demand--are excluded, the budget shows a deficit of NKr 28.8 billion, equal to 7.7 percent of GDP, excluding oil and shipping. In 1983 and 1984, the figure was 7.2 percent.

Because of price and cost developments, it is necessary to slow down the strong credit expansion that has been taking place in 1984, even though part of it is a consequence of the abolition of direct regulation of bank lending from the start of 1984. On the basis of the present credit and fiscal policy stance, the increase in the money supply--essentially broad money--is expected to be 10.9 percent in 1985, compared with an estimated 12.8 percent in 1984.

Until recently, direct control has been used quite extensively to influence the volume and terms in the credit market. Throughout the last few years, however, the authorities have sought to prepare the ground for pursuing a more market-oriented policy. An efficiently functioning money market is regarded as an important prerequisite for such a policy, and, in the supplementary budget bill presented earlier this month, the Government announced that steps will be taken to bring about further development of the money market in Norway.

A first step will be to develop a market for certificates of deposit as well as for loan certificates. This will promote greater clarity about borrowing terms and yield on financial assets. Initially, banks, private finance companies, and enterprises will be allowed to obtain finance from the certificate markets, while the so-called credit enterprises will, as previously, be referred to the long-term bond market. For the banks, the bond-investment obligation will be rescinded, and for the life insurance companies it will be substantially reduced. The issue control will also be further liberalized. These changes will represent an important contribution to the further development of an efficiently functioning bond market.

Norway's external assets and liabilities showed a gross debt at the end of 1983 of about NKr 225 billion, while gross claims--including the foreign exchange reserves--amounted to about NKr 135 billion. In 1984 and 1985 the net debt will decline as a result of the current account surplus on the balance of payments, but the reduction will be somewhat smaller than estimated at the time of the consultation discussions. Norges Bank's foreign assets have increased substantially in 1984 as a result both of the current account surplus and of a substantial short-term capital inflow to the banks. In addition, capital inflow has taken place as a result of nonresidents' purchases of Norwegian bonds.

In recent years, Norway's foreign exchange earnings have increasingly derived from oil and related activities, incomes and activities that are extremely vulnerable. The authorities nevertheless feel that the strengthening of the net external position and the present level of foreign exchange reserves make

it possible to ease exchange regulation somewhat as well as to make certain changes in the guidelines for the investment of foreign exchange reserves. Thus, the degree of liquidity may be reduced for part of the foreign assets. It has therefore been decided that Norges Bank can invest funds abroad in such ways that they will no longer be counted as ordinary foreign exchange reserves. Furthermore, Norges Bank will start placing foreign exchange deposits with Norwegian banks according to the same main principles as those currently applying to deposits with foreign banks.

These changes should be viewed in the light of the liberalization under way with regard to outward capital movements. As part of this process, a series of changes was introduced last summer. Norway is prepared to implement further changes aimed at giving enterprises that have earnings in foreign exchange greater freedom in using these earnings. This may result in a slower growth in the foreign exchange reserves in the period ahead than if the policy had remained unchanged.

Norwegian enterprises with both income and expenditures in foreign exchange have at present a limited permission to maintain short-term working accounts with foreign banks. This arrangement will be substantially liberalized with regard to the prior conditions for opening such accounts, as well as to the maximum amount and maturity of such deposits. Norwegian enterprises are at present allowed to purchase foreign bonds for exchange rate hedging. In the future, the Norwegian authorities will give private persons and companies general permission to purchase quoted foreign bonds denominated in foreign currencies up to a maximum of NKr 1 million for persons and NKr 5 million for companies. Moreover, Norwegian banks and insurance companies will be allowed to grant loans in Norwegian kroner to borrowers abroad and to the oil sector. For 1985, a total amount of NKr 5 billion has been stipulated for such loans, which will be exempted from reserve requirements, and so on.

The staff report provides an exhaustive and balanced description of the discussion in Oslo about Norway's exchange rate policy and clearly reflects the Norwegian points of view.

Norway will continue to pursue a liberal trading policy, and further measures in favor of the developing countries are planned. Official development assistance (ODA), which in 1984 is estimated to equal 1.05 percent of GDP, will also be kept high in the years to come.

Ms. Bush stated that the Norwegian authorities had made good progress in adapting their economy to the development of a large oil and gas sector and in promoting the recovery of economic growth with increased price

stability. Real GDP growth of 2 percent to 2 1/2 percent in the non-oil sector, fairly strong investment, an expected rise in the rate of job creation, and the sharp deceleration of inflation from nearly 14 percent in 1981 to 6.25 percent in 1984 all attested to the recent good economic performance.

Despite some uncertainties about the future, the oil and gas sector represented a source of economic strength, Ms. Bush considered. Moreover, the authorities' objectives of maintaining both a reasonably diversified non-oil sector in tradable goods and services, as well as a low level of employment, were reasonable. The rapid rise in government employment, however, was cause for concern, especially since the growth of government spending had been concentrated in transfer payments. Nevertheless, it was noteworthy that nominal wage growth had slowed from nearly 12 percent in 1981 and 1982 to about 7 percent in 1984, and that labor costs had decelerated from 11 percent in 1981 to about 3.5 percent in 1984. Those were clearly important factors behind price deceleration, and she agreed with the staff that domestic cost control should be the main tool for ensuring continued competitiveness. In fact, the much stronger than expected current account position provided some favorable policy options.

As the authorities had said, domestic spending of oil revenue should be limited, Ms. Bush continued, so that the exhaustion of that natural resource would be offset to some extent by a buildup of other foreign assets. That buildup should help to keep adjustment pressures on the non-oil sector within tolerable limits and to insulate the economy somewhat from the volatility of the oil market. The sharp reduction of foreign debt, special arrangements for investing balance of payments surpluses for longer-term use, and the relaxation of capital controls would all facilitate that outcome.

As to the marginal shift that had occurred in domestic demand policy, Ms. Bush observed, the use of the budget deficit "adjusted" to exclude oil revenues seemed to be a useful barometer for measuring performance. The estimated deficit of 7.7 percent of GNP for 1985, cited by Mr. Tvedt, showed a steady upward creep of the deficit ratio; a somewhat lower deficit might provide some margin for error. Moreover, the share of government spending in GDP of 50 percent constituted a heavy claim on domestic resources. Although the growth of transfer payments, especially pensions and transfers to municipal governments for social purposes, were a common phenomenon in industrial countries, experience in Norway and elsewhere suggested the need for careful monitoring of those developments--especially if the goal of reducing marginal income tax rates were to be achieved.

With regard to monetary policy, Ms. Bush commented, like the staff, she doubted whether the sharp rise in broad money of about 23 percent in 1983-84 could fail to have a negative effect on inflation in 1985. The dismantling of various direct controls, especially on interest rates, should make monetary policy a more modern and effective tool of economic

management and should help to avoid the disruptions created by periodic disintermediation and reintermediation as financial flows escaped from, or re-entered, banking channels.

The Norwegian authorities' generally liberal trade policy--except for agriculture and textiles--and their recent partial relaxation of capital controls were commendable, Ms. Bush remarked. She welcomed their support for extending GATT activities into the area of services, their compliance with Tokyo Round commitments, and the planned national treatment for foreign banks in Norway. She hoped, however, that the massive subsidies for agriculture could be reduced and eliminated, and that greater priority could be given to adjustment programs.

Mr. Goos remarked that, by international standards, Norway's economic performance was to be envied. Although that performance was largely based on the country's oil and gas resources, it could also be ascribed to prudent economic policies, particularly with respect to the use of oil revenues. In that regard, the authorities' considerations concerning the limitation on domestic spending of oil revenues, listed on page 5 of SM/84/266, were indeed appropriate.

While the macroeconomic figures presented a favorable economic picture, they also revealed considerable flaws, Mr. Goos continued. Perhaps the most worrisome was the fast growth of public transfer payments and government expenditures, which respectively accounted for more than one third and no less than one half of non-oil GDP. Unfortunately, those transfer payments were expected to increase even further owing to political decisions and statutory arrangements. Apparently a large part of transfers and expenditures was being devoted to supporting uncompetitive enterprises and financing rapidly increasing employment in the public sector.

While he appreciated the authorities' concern for maintaining high employment, Mr. Goos went on, that policy could be counterproductive in that it tended to solidify or even exacerbate structural rigidity. That in turn would reduce the employment-generating power of the traditional sector as well as its international competitiveness. Since the authorities attached great importance to maintaining a competitive traditional sector as a shield against the risk of deteriorating oil revenues, they should give greater priority to phasing out subsidies.

The task of maintaining and strengthening mainland competitiveness could be resolved much more efficiently by better control of domestic price and wage pressures, Mr. Goos considered, and corrective action was clearly needed. Chart 1 of SM/84/266 showed manufacturing output not only lagging behind output in other industrial countries, but even declining in absolute terms. At the same time, there were clear indications that that worrisome trend was largely due to wage costs. Thus in 1982, 18 percent of all employees in manufacturing had earned wage incomes higher than the value added produced by them. Furthermore, that share was assumed to have reached 29 percent of those employed in the export manufacturing industries.

While the authorities had justified the subsidies in part by the need to compensate for the cost disadvantages of production in isolated communities, he wondered whether it would be more appropriate to allow for greater wage differentiation between different areas. In the circumstances, the tendency toward egalitarian wage settlements did not appear appropriate.

He was in broad agreement with the staff's recommendations concerning other prescriptions to contain wage and price pressures, Mr. Goos added. In particular, fiscal policy should adopt a restrictive stance--the more so since the ongoing recovery would probably be more buoyant than expected earlier. Under such circumstances, an adjusted budget deficit of 7.7 percent of mainland GDP, as envisaged for 1985, was clearly on the high side. In assessing the appropriateness of the fiscal policy stance, Directors should keep in mind that the deficit for 1985 would be considerably higher than in 1982 and 1983, when the economy had been in a moderate recession.

Consistent with the objective of containing price and wage pressures, there was a clear need to discontinue an accommodating monetary policy, a need underlined by the upward revision of import price projections for 1985, Mr. Goos observed. He therefore welcomed the continued efforts of the Norwegian authorities to dismantle the existing monetary controls, including those on interest rates.

As the staff had said, given the country's strong external position, a lowering of the exchange rate was not an acceptable substitute for appropriate domestic demand policies, Mr. Goos concluded. Deliberate exchange rate changes were justifiable only as an instrument for correcting economy-wide problems, not as a remedy for specific sector problems. In that context, the authorities' view that only appropriate domestic policies could secure the competitiveness of the traditional economy in the longer run was reassuring. In concluding, he supported the staff's appraisal.

Mr. Polak said that Norway's problems were mostly problems of wealth, which it was handling well. He agreed with the staff appraisal except for one point: the staff did not approve of Norway's two devaluations by about 2 percent each during 1984; that view raised the issue of how the Fund was dealing with exchange rate surveillance.

The purpose of the devaluations had been to protect the competitiveness of Norway's non-oil sector in the face of wage increases higher than those in competitor countries, Mr. Polak observed. As a general rule, the staff was correct that a country with one booming industry--in Norway, oil--had to accept that other tradable goods industries were handicapped; but Norway probably had a better chance for the success of non-oil industries than any other oil-producing country, the tradable goods industries having been developed before the oil. Oil production in Norway was deliberately held down, and a good part of oil revenue was kept abroad to avoid overheating the economy. Probably as a result of those policies, Norway had been relatively successful in maintaining its production of tradable

goods, although there had been a modest decline in manufacturing output. For a country that still believed in full employment and still almost managed to achieve it, maintenance of manufacturing was particularly important because manufacturing was more labor intensive than oil production.

The best way for Norway to consolidate its mixed economy was to control domestic costs, Mr. Polak continued. Norway did have a definite wage policy, and centralized wage bargaining had produced increases of only 1 percent in basic wages in both 1983 and 1984. Drift, however, had produced total wage increases in the range of 7-8 percent, well above those in competing countries. To redress the 4-5 percent loss in competitiveness, in 1984 Norway had resorted to a devaluation of the same magnitude. Although devaluation carried some risk of raising inflation and thereby defeating its original purpose, such a second-best policy, given normal frictions and the small percentages involved, might well succeed in keeping Norway reasonably competitive at the cost of some small devaluations every few years.

Some years previously, Norway had been a member of the European Monetary System (EMS), Mr. Polak recalled, and he would like to know whether, if it were currently a member of the EMS--the only operating par value system at present--would have been allowed to devalue. Given Norway's large current account surplus, he believed that the answer would certainly have been "no": like the staff, the EMS would have steered Norway toward domestic adjustment. However, if Norway had been in the EMS, it would not have been in its present predicament, which arose from the authorities' practice of pegging the currency to a basket with a 25 percent dollar component. Over 1984 as a whole, despite two devaluations, the Norwegian krone had not depreciated against the European currency unit (ECU).

Under the revised Article IV, Mr. Polak remarked, countries theoretically could have the exchange rate regime of their choice, provided they had the "right" rate; according to Section 1, paragraph (iii), the rate chosen must be neither so high as to prevent "effective balance of payments adjustment" nor so low as to allow the member "to gain an unfair competitive advantage." That was the theory, but it was hardly the practice. To begin with, for countries with floating rates, the Fund had been unable to insist on the right rate, and for countries that pegged, the Fund's approach had been somewhat asymmetrical. Under the original Articles, the Fund had had to concur in changes of the peg, but its actions had been constrained when a member did not change the peg when it should have done so. Therefore, the Fund had never fully operated on that theory either. It had, however, taken the initiative on numerous occasions in advising countries to devalue.

Although the Fund had strengthened its surveillance in recent years, the case of Norway showed that the staff looked much more closely at exchange rate action than at exchange rate inaction, Mr. Polak commented. If the Fund was equally concerned about action and inaction, what were

the criteria by which it decided its position? Would it concur with Norway's devaluation because the action did not lead to a reduction in the real effective rate, or disagree, because Norway seemed to have a solid current account surplus? If the surplus were the guiding criterion, would the staff have applied the same critical judgment: would Norway have been advised to revalue, if it had managed to maintain a real effective exchange rate through better control over wage rates?

Mr. Sugita expressed general agreement with the staff's analysis and appraisal. The Norwegian economy had successfully adjusted to the structural changes caused by the development of the oil sector and the fall in oil prices. Inflation had decelerated to a rate of just over 6 percent, GDP was growing moderately, the current account showed a substantial surplus, and the Central Government would fully repay its external debt by early 1985.

He would be interested to learn how North Sea oil revenues had been spent, Mr. Sugita remarked. The staff report indicated that the adjusted budgetary deficit amounted to nearly 7 percent of GDP every year, and that the rapid increase in expenditure was accounted for by rising transfers to municipalities. In addition, Chart 5 of SM/84/267 showed that the local government had absorbed much of the growth in the labor force. He invited the staff to comment on the areas and occupations in which the increased municipal work force had been employed.

The burden of adjustment had fallen more heavily on the external side than on the domestic side, Mr. Sugita noted. The krone had depreciated by 4 percent between December 1983 and October 1984, while fiscal and monetary policies had been largely accommodative to wage increases, which had been high by international standards. He agreed with the staff that downward movements in the exchange rate were undesirable in view of the strength of Norway's present external position.

Maintaining the competitiveness of the traditional industries was of the utmost importance, Mr. Sugita considered, but that objective should be achieved through the enhanced efficiency of the sector and not through an exchange rate policy associated with a higher rate of inflation. He therefore welcomed the authorities' determination to prevent fiscal expenditure for 1985 from exceeding that of 1984 by 8.5 percent and urged some degree of restraint in monetary growth. Mr. Tvedt had indicated that liberalization with respect to outward capital movements was under way, and he encouraged the Norwegian authorities to carry that liberalization further, as it would contribute to increased efficiency in the allocation of resources. Finally, with few exceptions, Norway was firmly committed to free trade.

Mr. Ismael stated that he was in broad agreement with the staff's appraisal of the Norwegian economy. Considerable progress had been made in the past two years: a better balance had been achieved between the

oil and the non-oil sectors, the rate of inflation had been reduced, and Norway's external position had dramatically improved. Such developments were attributable not only to the general recovery of the world economy, but also to the prudent policies followed by the authorities.

A number of areas, however, needed continued consideration, Mr. Ismael remarked. First, the expected significant slowdown in investment in the oil sector following the sharp increase in 1984 would lead to a marked deceleration of growth in that sector, while the so-called mainland sector would continue to expand at a rate of 2 percent to 2 1/2 percent. The authorities should therefore continue to strive for a diversified production base that would not only improve the position of the Norwegian economy to withstand the volatility of oil prices, but would also provide greater employment opportunities, since the traditional sector was more labor intensive.

Second, wage and price inflation, though declining, remained on the high side, Mr. Ismael continued. Despite the authorities' policy designed to limit domestic spending of oil revenues, the net effect of the budget--in particular, wage settlements in the public sector, tax decreases, and transfer payments, which were undertaken to support real disposable incomes--remained expansionary. He therefore supported the authorities' stated intention that the budget should not be weakened. He agreed with the staff that a more active use of monetary policy would provide a more effective instrument of demand management. A somewhat tighter monetary policy might be appropriate, and he welcomed Mr. Tvedt's statement that the authorities intended to take steps in that direction.

Third, Mr. Ismael remarked, the sharp turnaround in the current account from what had been expected 18 months previously was due in part to the effective depreciation of the currency. He appreciated the need to keep Norwegian products competitive in view of the uncertain outlook for the medium term and agreed that a satisfactory competitive position could be assured, in the longer run, only by domestic policies. Nevertheless, it was unclear why the authorities had chosen to keep the value of the Norwegian krone relatively low when the balance of payments position was extremely sound and wage and price inflation remained practically unchanged. He wondered whether the staff had calculated the effect of a small upward adjustment of the krone on the current account, prices, and employment.

On other matters, Mr. Ismael asked whether Mr. Tvedt could give some indication of what measures, if any, would be taken to prevent any expansionary effect on domestic liquidity resulting from the decision to permit foreign exchange deposits in Norwegian banks. He welcomed the authorities' intention to liberalize trade in agricultural products and textiles and looked forward to the results of the study on ways to increase imports from less developed countries referred to in page 12 of the staff report; a reduction of subsidies to Norway's own producing sectors would be helpful in that connection. Finally, he commended the authorities for the increase

in ODA disbursements from 0.82 percent of GDP in 1981 to 1.05 percent of GDP in 1984, and welcomed Mr. Tvedt's statement that the authorities intended to keep ODA at a high level in the years to come.

Mr. Ainley stated that the Norwegian economy had adjusted well to the structural changes caused by the development of the oil sector and, more recently, to the impact of the world recession. All the main indicators--internal and external--were satisfactory, and the short-term outlook was for more of the same.

Norway was thus in a favorable position compared with many Fund members, Mr. Ainley continued. There were only two or three clouds on the horizon. The first was the uncertain state of the world oil market. However, the authorities had planned ahead carefully and had managed their reserves prudently. The recent changes in reserve management policy were part of a strategy aimed at diversifying foreign investment by currency and by maturity, changes that should help to protect the economy against future fluctuations in the oil market. It should also make new medium-term funds available in the international capital markets, which could benefit the international adjustment process.

The second, closely related concern was the need to strengthen and diversify the traditional tradable goods sector, Mr. Ainley considered. Although manufacturing investment had recovered strongly after a period of stagnation, the traditional sector remained heavily dependent on government subsidies. While he fully understood the authorities' wish to maintain employment in manufacturing, he agreed with the staff's judgment, on page 9 of SM/84/267, that those subsidies had hampered structural adjustment by preserving unprofitable activities. More emphasis should therefore be given to restructuring declining industries and shifting resources to areas of comparative advantage. He welcomed the recent initiatives taken by the Government aimed at speeding up adjustment and reducing the need for subsidies, which should help Norway to lay more solid foundations for broadly based growth in the future.

The third concern was Norway's still high cost/price inflation relative to that of its trading partners, Mr. Ainley remarked. It was particularly important to restrain the growth of domestic labor costs in order to maintain competitiveness in the manufacturing sector in the short term and to create new opportunities for growth and employment over the medium term. The Government should set an example of wage moderation in the public sector and do everything it could to encourage firms to link wage increases more closely to productivity gains.

A sustained reduction in inflation would also require a cautious financial policy, Mr. Ainley noted. As the staff had suggested, the authorities should keep government spending firmly under control, particularly since it had risen to about 50 percent of mainland GDP. Much of the increase in recent years had been due to the rapid growth of transfer payments and social benefits. The more or less automatic increase in those payments--which were index-linked--could undermine the traditionally

prudent fiscal stance. That problem had to be faced urgently; he was therefore gratified to learn that the authorities were working on possible changes in the indexation arrangements and would appreciate more information about them from the staff or Mr. Tvedt. He would also like to know more about the plans to simplify the tax system. As he understood it, the aim was to enhance incentives, but whether for household or business saving, or both, was not clear.

A cautious monetary stance also seemed appropriate in view of the rapid rate of credit expansion so far in 1984, Mr. Ainley remarked. In the past, the effectiveness of monetary policy had been hampered by the shortage of suitable policy instruments and by reliance on ineffective controls. He therefore supported the authorities' attempt to develop new policy instruments, together with the steps already taken to expand the financial market and promote greater competition in the financial sector. There would inevitably be transitional problems, particularly with monetary control, in moving away from a highly regulated system; those would require close monitoring. Over time, however, such moves should allow monetary policy to become a more effective tool of demand management.

Finally, Mr. Ainley commended the authorities for maintaining a liberal trade system. The recent move to liberalize the import licensing system and implement ahead of time the roll-back measures agreed by the OECD were a good example to other members. He also noted with satisfaction the authorities' record on foreign aid, which would again exceed 1 percent of GDP in 1984, and that Norway's contribution to ODA would be kept high in the years to come.

Mr. Zecchini stated that while the Norwegian economy was experiencing a particularly favorable situation marked by a brisk rate of economic activity, a surplus in the external accounts, and declining inflation, it faced some critical structural and policy problems whose relevance was likely to become more apparent over the medium term. First, and most important, was the expansion of the oil-producing sector and its impact on the rest of the economy. The authorities had recently decided to support the traditional tradable goods sector and limit the economy's dependence on the vagaries of the international oil market. That difficult task required strong, consistent action on many fronts, and there was the risk that some aspects of the current policy stance might be inconsistent with that effort as well as with a balanced approach to external adjustment in the international economy.

The second problem was the structural transformation of the techniques of monetary control, Mr. Zecchini continued. Although the evolution in favor of more market-oriented procedures was positive, unfortunately the Norwegian authorities did not at present seem to be willing to proceed decisively toward financial and exchange liberalization, and it was doubtful that they could effectively control monetary policy in the present, mixed system.

Since becoming a net oil exporter in 1975 until the first part of 1982, Norway had displayed the typical characteristics of an economy dominated by the effects of an oil surplus, Mr. Zecchini noted. Sizable improvements in the current account and upward pressure on the real exchange rate had alternately or jointly characterized the external position. Domestically, the traditional manufacturing sector had lost competitiveness, and its share in total output had declined; its performance had been particularly poor in terms of productivity and fixed investment. The productivity of the manufacturing sector relative to the rest of the economy had declined from 86 percent in 1979 to 69 percent in 1983. At the same time, gross accumulation of fixed capital in volume terms had been somewhat negative, implying a net decrease in the productive base, while current public expenditure, which had increased markedly in 1975-78, had continued to expand, particularly transfers to households and to enterprises. Oil revenues had, to a large extent, been used to finance higher levels of employment and personal income, as well as to improve Norway's foreign financial position. Household disposable income, having risen by an average of 4.9 percent in real terms in 1974-76, had risen again by 4.2 percent in 1981. In sum, the country had reacted to the oil shock with a strategy of "accumulation plus consumption."

Recognizing the adverse medium-term implications of that course for the country's productive base, Mr. Zecchini continued, the authorities had gradually changed their priorities, attaching greater importance to preserving the strength of the manufacturing sector. The difficulty of pursuing that goal and at the same time attaining internal and external balance was apparent: manufacturing and oil were both tradable goods, so that exchange rate adjustment could not be used to modify their relative price; while devaluations could stimulate production and exports in the manufacturing sector, in the oil sector they would add further to Norwegian receipts of foreign exchange. That had been precisely the case in Norway since 1982. The depreciation of the krone had laid the basis for a lively expansion of traditional exports and, coupled with the growth of oil exports, had resulted in an undue magnification of the external surplus.

The authorities' policy approach had implications for the international economy, as it exemplified a deep asymmetry in the process of adjusting external imbalances, Mr. Zecchini suggested. A country endowed with a structural oil surplus had to take significant steps to ease the adjustment effort of deficit countries, through trade in non-oil products or through the external capital account. To the extent that a country resorted to exchange rate depreciation to support the traditional manufacturing sector, and at the same time maintained significant impediments to capital outflows, it was actually shifting an increasing burden of external adjustment to deficit countries.

Other means were available to support the traditional sectors that would allow for exchange rate movements conducive to a balanced pattern of external current accounts in the European as well as the world economy, Mr. Zecchini went on. First, tighter controls on domestic costs,

particularly on the trend in unit labor costs, could maintain, rather than boost, the external competitiveness of those traditional sectors. Second, a strong drive toward larger productive investment was also necessary. In the seven-year period to 1981, although the share of manufacturing investment in the total had remained roughly constant, relative per capita output had shown a marked slowdown. In 1983-84 fixed investment in manufacturing had expanded, but mainly for cyclical reasons and secondarily because of the exchange rate depreciation. In contrast, a consistent policy effort was needed to stimulate a steady process of capital formation and particularly to improve the quality of investment in order to raise productivity. In sum, to revitalize the non-oil tradable sector, the authorities should move from a strategy of "accumulation plus consumption" to one of "accumulation plus productive investment plus control over domestic costs."

The recent evolution in monetary policy toward more market-oriented procedures in Norway paralleled similar developments in other European countries, Mr. Zecchini noted The main factors underlying that evolution were the recognition that administrative ceilings could imply short-run inefficiency in the allocation of credit flows and were likely to become ineffective in the medium term because of the substitutability of various forms of credit. Norway had long relied on administrative measures to control directly both aggregate credit and credit costs. In countries where credit ceilings had been abandoned, the reaction had been a quick reintermediation by banks in the credit system, usually accompanied by statistical distortions and serious difficulties for policymakers in predicting and controlling financial aggregates. Empirical evidence showed that the abolition of credit ceilings required that the monetary authorities more actively use traditional policy instruments, and that larger fluctuations in lending rates were necessary to control credit aggregates, especially in the initial period when those aggregates were likely to be unstable.

It was not clear to him how the Norwegian authorities intended to exercise financial control by lifting the ceilings on credit flows while at the same time maintaining the ceilings on interest rates, unless the liberalization were replaced de facto by other forms of direct controls such as moral suasion, Mr. Zecchini remarked. The staff had argued along similar lines on page 48 of SM/84/267. What were the views of the Norwegian authorities on that problem, and how would outstanding credit be controlled in the face of fluctuating demand by the private sector?

Mr. Blandin commented that the Norwegian economic situation was an enviable one. The rate of growth had been reasonable, inflation had slowed to 6 percent, the current account was in substantial surplus, the rate of unemployment was notably low, and by 1987-88 Norway would probably have eliminated its external debt.

As for short-term management, Mr. Blandin continued, the policy followed by the authorities appeared particularly sound and prudent; consequently, the advice to be given was for fine-tuning. The staff's

recommendations were appropriate. In particular, further efforts should be made to tighten credit expansion in order to give monetary policy a more effective role in demand management. Greater flexibility should also prevail in interest rate policy. On the fiscal side, management of the so-called adjusted deficit was generally appropriate. The claims of government expenditure upon domestic resources, however, had reached a high level, and the trend should now be reversed.

As to exchange rate policy, Mr. Blandin stated that he shared the staff's doubts about the adequacy of the depreciation of the krone in 1984. He wondered whether that policy--despite large current account surpluses--had fed inflationary pressures and was not at least partly responsible for the relatively high rate of price increases in 1984. In the light of Mr. Polak's comments, he would appreciate further staff comment on Norway's exchange rate policy.

Norway's highly favorable economic situation afforded the authorities a great opportunity to follow an appropriate medium-term growth path, Mr. Blandin added. That entailed putting in place a sufficiently strong industrial sector so that a reasonable balance of payments position and growth rate could be achieved independent of oil-sector activity. He concurred with the Norwegian authorities that that was the only way to attain their ambitious employment goal. The competitiveness of the traditional sector should, however, be improved through strict control of domestic costs rather than through the downward adjustment of the exchange rate; such a policy should give greater priority to eliminating subsidies to the competitive sector and to relaxing exchange controls further. The Norwegian authorities should also move toward a policy aimed at stimulating capital formation and productive investment. In concluding, he commended the authorities for their continuous and substantial efforts toward assisting the developing countries.

Mr. Munthali stated that he was in broad agreement with the staff's appraisal of recent economic developments in Norway. Since the 1983 Article IV consultation, the Norwegian economy had continued to show steady and satisfactory progress. Total GDP had grown steadily in the past two years, and "mainland" GDP, which excluded shipping and oil activities, had strengthened somewhat. The rate of price increases, though higher than in other industrial countries, had decelerated, and unemployment had fallen to only 3 percent. Though still worrisome to the authorities, the unemployment rate was lower than in many other industrial countries and elsewhere. The external sector had also strengthened, thanks to the increase in earnings from both traditional exports and oil and gas exports, the weakening of the world oil market notwithstanding. Earnings from the energy sector had particularly benefited from the appreciation of the dollar.

Both the medium-term strategy for the traditional export sector and the manner in which oil and gas revenues were to be used to ensure the stable growth of the economy as a whole were noteworthy, Mr. Munthali considered. To keep unemployment as low as possible, the traditional

export sector would have to be strong and competitive, since that sector--particularly manufacturing--had greater potential for absorbing the increasing labor force than the capital-intensive oil industry.

The authorities' desire to reduce unemployment further was understandable, since the improvement in the standard of living had undoubtedly produced new anxieties about unemployment, and any increase, even transitional, could prove intolerable, Mr. Munthali observed. It was not, however, clear from the staff papers whether the objective was to achieve full employment. He wondered what the authorities considered to be a tolerable level of unemployment and whether the underlying causes of the current unemployment were mostly structural.

To keep the traditional export sector competitive, the authorities would have to remain firm in their fight against inflation, Mr. Munthali continued. Inflation could be tempered in part by appropriate tightening of monetary policy and also by placing a lid on wage costs, which would, in turn, encourage firms to minimize labor shedding. That would not be an easy task; current developments pertaining to wage settlements had not been encouraging. Moreover, the use of exchange rate action rather than domestic policies to improve competitiveness had serious international implications. While the authorities' desire to take timely exchange rate action was understandable, he hoped that domestic policies would become a more prominent tool for ensuring the competitiveness of the traditional export sector.

Finally, Mr. Munthali observed, even after surpassing the UN target, the Norwegian authorities had reaffirmed their intention to maintain official development assistance relative to GDP at its current high level. That action was commendable and important when considered against the background of a steady and continuous decline in the size and quality of global external aid at a time when financial assistance was most required by the marjority of the recipient countries.

Mr. Jayawardena agreed with the staff's appraisal. The maintenance of growth and investment, a strong balance of payments, and the containment of inflationary pressures reflected the measure of successful adjustment in the Norwegian economy, which had come to be increasingly dominated by a volatile oil and gas sector. The growing oil revenues had to a large degree been prudently managed. Nevertheless, as during the discussion at the previous meeting of the Article IV consultation with Denmark (EBM/84/20, 2/8/84), several Directors had noted their concern about public finances--in particular, the large deficit and high transfer payments--as well as the accommodating monetary stance.

With the development of the gas and oil industry, the traditional manufacturing sector had suffered and had been kept alive by government subsidization, Mr. Jayawardena continued. That practice did not augur well for the future, since Norway must continue to remain competitive in the non-oil tradable sectors, and prudent long-term management should not be based on the continued buoyancy of the energy sector. He appreciated

that there were some difficult structural problems: the staff report had noted that whole communities in Norway were sometimes dependent on a single industry. In that situation, the optimal policy might have been to contain the impact of oil and gas revenues while progressively liberalizing the rest of the economy. Considering the structure of the Norwegian economy, however, such a free-market solution might entail great social costs. Consequently, a transitional approach might be helpful in furthering the diversification and restructuring of the economy. In that regard, he welcomed the liberalization of the money market. Less concern with the objective of full employment, and a more flexible exchange rate policy and looser fiscal stance, might also help to promote structural adjustment.

Nevertheless, Mr. Jayawardena concluded, the remarkable success and stability of the Norwegian economy in maintaining reasonable growth and employment and in moderating inflation were noteworthy. He commended Norway for its relatively open trade system. Its record on assistance, which was expected to reach 1.05 percent of GDP in 1984--well over the UN target of 0.7 percent--was outstanding, and the authorities' intention to maintain assistance at such high levels in years to come was commendable.

Mr. Coene remarked that the Norwegian economy was in a comfortable position following its adjustment to the development of the oil sector. Developments since the 1983 Article IV consultation had been better than expected, notably on the external front. The current account was in surplus, GDP was growing, inflation was slowing, unemployment remained well below the average of other industrial countries, and the external debt was expected to disappear. That favorable economic outturn was attributable not only to the performance of the oil sector, but also to a large extent to the sound policies pursued by the authorities. Norway's only major concern was how to secure that comfortable position for the future.

While the exploitation of oil and gas resources had been the motor of the Norwegian economy's overall excellent performance, Mr. Coene added, he shared the authorities' concern about the domestic absorption of export proceeds from oil. Excessive absorption threatened to crowd out the non-oil sector further, especially the manufacturing sector, which was important for generating employment. Oil income had therefore to be channeled and, in that regard, the authorities' policies to shield the domestic non-oil sector from excessive absorption through the so-called adjusted fiscal budget deficit seemed fully appropriate. Moreover, the system of predetermining the amount of domestic absorption would shelter the domestic sector from fluctuations in the price and output of oil. Indeed, a similar system could be usefully applied by other countries that were heavily dependent on receipts from certain primary commodities. In Norway, the creation of a foreign exchange fund to serve as a buffer against the vicissitudes of the oil market was welcome. The authorities might also consider liberalizing capital flows so as to encourage the accumulation of external financial assets, instead of relying on reserve accumulation by the Norges Bank. That change would also facilitate the management of domestic liquidity.

The authorities had justified the recent devaluations by citing the need to secure the competitiveness of the domestic sector and employment opportunities, whereas the staff had felt that that goal could have been better accomplished by containing domestic costs, especially wages, Mr. Coene noted. The authorities' approach would have been a valuable solution if export proceeds from oil were expected to falter in the medium term, requiring the substitution of new export revenues for lost oil revenue. In the present circumstances, however, the authorities' objective was a strongly competitive domestic sector, which might be better achieved by relying on the containment of domestic costs. There was no need at present to shift resources to the export sector through a change in relative prices; the need was rather to make the domestic sector more profitable, particularly to increase investment and employment in the non-oil sector.

The exchange rate adjustment had also been justified by the need to maintain competitiveness vis-à-vis other European countries as the krone appreciated against their currencies, Mr. Coene observed. The basket for the krone was, however, weighted by exports in manufactured products and was thus specifically geared to maintaining the competitiveness of the manufacturing sector. He would appreciate the staff's comment on that issue as well as its view on the appropriateness of the basket.

In future, monetary policy, including policies pertaining to interest rates, should be geared toward more modern instruments and away from mere controls and administrative interference, Mr. Coene remarked. In checking inflation and containing domestic costs, monetary policy should be implemented more consistently and more restrictively.

In concluding, Mr. Coene noted with satisfaction that Norway would continue to pursue a liberal trading policy and would maintain its official development assistance at a high level in the future. He concurred with the staff's suggestion that consultations with Norway be kept on an 18-month cycle.

Mr. Pérez stated that the performance of the Norwegian economy over the past 18 months had been commendable; although some problems still remained, Norway's general economic position was more solid. Gross domestic product had increased by 3.2 percent in 1983 and by 3.4 percent in 1984. Excluding oil and shipping production, the rate of growth had been 1.6 percent in 1983 and 2.4 percent in 1984, owing to an upward trend in investment in non-oil sectors. Moreover, the rate of inflation had decreased from 8.4 percent in 1983 to 6 percent in 1984, and the unemployment rate had begun to decrease after three years of moderate growth, reaching an enviable figure of 3 percent, although it still remained a matter of concern to the Norwegian authorities.

Since the mid-1970s, economic events in Norway had been dominated by changes in the sectoral composition of aggregate supply and demand resulting from developments in the oil and gas sectors, Mr. Pérez observed. Although the oil sector had provided an increase in public sector revenues,

employment, and wages, it had also contributed to weakening the competitive position of the rest of the trade sector as a result of the combined effects of a strong currency and higher labor costs than those of Norway's main trading partners. Chart 2 of SM/84/267 showed how production in manufacturing industries had lost ground during the past few years. Nevertheless, since the beginning of 1983, a shift in that trend indicated that the authorities had achieved some success in laying the foundation for more broadly based growth in the future. Nevertheless, efforts should be concentrated toward the achievement of two aims: first, to restrain the growth of labor costs in order to maintain external competitiveness by means other than exchange rate adjustments such as those implemented during the past year; and, second, to encourage business firms to link wage increases more closely to gains in productivity in the non-oil sector in order to maintain the incipient takeoff and to strengthen that sector's position in the economy.

The steps taken in 1984 toward freeing the financial market were noteworthy, Mr. Pérez remarked. The move to a market-oriented monetary policy initiated in 1980 had been further strengthened by the removal of direct controls on bank lending. He welcomed the measures announced by the Government and reported by Mr. Tvedt to bring about further development of the money market, which would enable monetary policy to play a more active role in demand management.

In concluding, Mr. Pérez observed that the Norwegian authorities deserved to be commended for their commitment to continuing their efforts to strengthen free trade, as well as their excellent record in providing official development assistance.

The Deputy Director of the European Department stated that Norway's oil operations resulted in a flow of revenue to the Government, a large part of which had in practice been spent on transfers, particularly to municipalities. The resulting increase in employment in the municipal sector was largely the result of expanded services for health and education.

The staff's calculation of the effect of an appreciation of the krone was reported in Chart 3 of SM/84/266 for three medium-term scenarios, the Deputy Director continued. The impact of an upward adjustment of the real exchange rate by 2 percent each year to 1990 could be seen by comparing Scenario C with Scenario A.

Centralized wage bargaining had produced an increase in domestic wages of only about 1 percent, the Deputy Director remarked, while wage drift had added about 5-6 percent. That curious phenomenon had been developing steadily since the 1970s, when wage increases at the central level had been much larger, and increases at the local level much smaller. The latter could be explained by increased pressures in the labor market, notwithstanding the increase in unemployment, which was structural rather than cyclical. It was more difficult to determine why centralized wage bargaining had yielded such low figures, but perhaps the complex institutional system in Norway provided an explanation. If the social

partners could not reach agreement, they went to mediation; if that failed, further procedural steps were taken. In the past, the Government had sometimes intervened and even legislated wages. That sort of massive apparatus had caused the central partners to conclude that they would do best by keeping wage increases down at the central level, all the more so as the focus of wage negotiations in recent years had been on the likely evolution of disposable real incomes. Consequently, the Government's attitude on tax policy had become an element in the wage negotiations.

The authorities were studying the scope for tax reform as well as a possible modification in the indexation of social transfers, the Deputy Director recalled. Although there were, no doubt, particular propositions being considered, the staff did not have any details concerning definite proposals.

As for the Norwegian definition of full employment, the Deputy Director remarked, the present Government had not specified a particular figure. Table 9 in the paper on recent economic developments indicated that in 1979 unemployment had been about 1 1/2 percent to 2 percent; in his opinion, there would be much less emphasis on employment considerations if unemployment once again fell to that rate.

Norway's present currency basket was in fact constituted on the basis of manufactured exports and contained 14 currencies, the Deputy Director noted. Since the basket was based on the non-oil sector, it seemed appropriate for measuring the competitiveness of that sector. The main difficulty with such a basket was that wide fluctuations in major currencies caused inconvenience to particular exporters.

Whatever basket was used and whatever method of calculating the index was used, the pattern and level of exchange rates in 1983 and 1984 had produced large current account surpluses, with another fairly substantial surplus expected in 1985, the Deputy Director observed. In those circumstances, the staff did not agree with the authorities' argument for having made two, admittedly small, depreciations. If Norway had been a member of the EMS, it would in fact have had a greater degree of effective depreciation, the current account surplus would have been even larger, and presumably it would also have been consistent to argue for some appreciation of the krone.

As to the Fund's asymmetrical response to exchange rate action as opposed to exchange rate inaction, the Deputy Director of the European Department concluded, one general justification for the staff's having reacted to Norway's exchange rate actions was that a change in a pegged rate was highly visible and, in the case of the krone, had attracted critical comments from other countries, although those countries had not felt strongly enough to make any formal complaint. If Norway had been a member in the EMS and if the depreciation had been larger, the rate might not have been raised--no visible action having been taken--because the Norwegian rate would not have been badly out of line. Since an adjustment of 2-4 percent would seem rather trivial, the staff might not have pressed

for action to appreciate the exchange rate. The difference between the staff's response to action and inaction was perhaps that, in the first case, it was simply commenting on what had happened, whereas in the second it would be intending to provoke an event. In the latter, the staff would have to be very careful about coming forward with explicit recommendations for exchange rate action, and very sensitive to the need not to set off unnecessary market reactions.

Mr. Tvedt stated that, as several Directors had noted, the process of integrating the oil sector into the Norwegian economy was largely completed. Projections for the oil sector to 1990 pointed to the need for a non-oil tradable sector of appropriate size that could expand in a sustainable fashion. To that end, the policy of maintaining, or preferably improving, competitiveness would be important. Although there was a need to give high priority to medium-term objectives, a delicate balance had to be struck between successful implementation of such a strategy aimed at restructuring the economy and the maintenance of satisfactory levels of production and employment in the short run.

His authorities attached great importance to the maintenance of high employment, Mr. Tvedt continued, and that was also true of the Norwegian public; possible unemployment was by far the greatest worry of the average Norwegian. The results of an opinion poll conducted in the past year in the United States, Japan, and seven European countries, including Norway, indicated that 63 percent of the Norwegians interviewed cited unemployment as their main concern.

Several Directors had expressed concern that Norway's fiscal policy stance was too lax, Mr. Tvedt recalled. Although the approved budget showed an adjusted deficit slightly above the figure reported in the staff paper, he considered that fiscal policy was broadly appropriate. However, any further widening of the deficit should be avoided. Government transfers to ailing industries had declined in real terms in recent years, and further reductions were expected. Although such transfers were likely to hamper structural adjustment and labor mobility, due regard had to be paid to regional considerations. Government transfers to the private sector, particularly agriculture and fisheries, had recently been the subject of a commission study, and some action in that area was likely to be taken over the next year or two.

Chart 2 in SM/84/266 showed a sharp increase in employment in local government, Mr. Tvedt noted. As the Deputy Director of the European Department had explained, that development was mainly due to growth in health care and social services--partly as a result of changing demographic patterns--and in education, as well as increased responsibility on the part of local governments in those areas.

Suggestions made by Directors that Norway's monetary policy stance had been, and still was, too accommodating were relevant, Mr. Tvedt commented. In recent years, direct regulation of credit had been widely applied. However, as the result of a growing awareness among Norwegian

officials that direct regulation had become increasingly ineffective, steps were being taken to improve the efficiency of money and capital markets and to abolish direct controls. A relaxation of the present rather rigid interest rate policy also seemed necessary to improve monetary management.

As to wage policy, the Norwegian authorities--without being directly involved in negotiations between the parties in the labor market--had clearly indicated the outcome they would have liked to see, and at the same time, they had tried--through income tax reductions--to bring about more modest demands for nominal wage increases, Mr. Tvedt remarked. That approach had met with a fairly large degree of success in recent years; consequently, the concern expressed by many Directors during the Board's previous consultation discussion on Norway (EBM/83/109, 7/22/83), that the authorities could not rely on a tradeoff between income tax reductions and moderate wage settlements, had so far proved unwarranted.

The recent exchange rate adjustments had to be viewed in the light of large misalignments between major currencies, Mr. Tvedt considered. A small country with an open economy, such as Norway, could not avoid the difficulties stemming from such international exchange rate developments but could make adjustments to modify their effect somewhat. At present, he did not foresee any changes in the existing exchange rate regime, and the authorities had stated their intention to maintain a stable currency index through prudent demand management and supply-oriented policies.

The Chairman made the following summing up:

> Executive Directors commended Norway's economic performance since the 1983 consultation, in that it had combined rising output with a continued deceleration in inflation and a low rate of unemployment. Furthermore, external current account surpluses averaging 5 percent of GDP in 1983 and 1984 had made possible substantial repayment of external debt. Revised forecasts also showed that domestic demand in 1985 would be stronger than earlier assumed, but GDP growth would be modest because of a decline in investment in the oil sector.
>
> Directors noted that the wish of the Norwegian authorities to maintain a competitive non-oil traded goods sector and to reduce further the rate of inflation would require the pursuit of firm financial policies. Directors noted that the planned rise in the ratio of the "adjusted fiscal deficit" (i.e., excluding the effects of the offshore oil sector) to the mainland GDP in 1985 to 7.7 percent of GDP was not in consonance with the requirements of countercyclical policy. They urged maximum efforts at expenditure restraint, given the size of the public sector in Norway and the rapid growth in government employment and transfer outlays in recent years.
>
> Directors welcomed the steps toward liberalization in the money and securities markets taken in 1984 but observed that the

system of monetary management was still overcomplex, with key interest rates continuing to be subject to administrative control. This made control of the money and credit aggregates difficult. Directors shared the view of the Norwegian authorities that the pace of credit expansion should be slowed, but observed that the monetary stance had tended to be accommodating in the recent past and expressed doubts whether the planned monetary growth in 1985 was consistent with the objective of securing a further fall in inflation. The need for an early tightening of policy was emphasized. Directors encouraged the authorities to pursue more market-oriented policies and urged greater flexibility in interest rates.

Directors believed a moderation of wage settlements to be crucial if the authorities were to combine an increase in employment with a reduction in inflation. A firm position on public sector pay and a stricter financial policy stance would assist in the task of obtaining moderate wage agreements.

Directors judged that, despite the strong balance of payments position, it remained important for Norway to maintain a non-oil traded goods sector of an adequate size. To this end, the efficiency of the enterprise sector needed to be enhanced through higher productive investment, and international competitiveness safeguarded. Directors pointed to the structural weaknesses that had developed in the economy and noted the high subsidies paid to several sectors of the economy, which should be scaled down in the interests of promoting structural change, greater efficiency, and labor mobility. In order to minimize structural adjustment pressures over the medium term, the domestic spending of oil revenues should be limited at more or less its current level. Directors welcomed the ongoing liberalization of outward capital movements and encouraged the authorities to take further steps in that direction.

Directors emphasized that the defense of competitiveness should be conducted through containment of domestic costs; success in this endeavor would also help to protect employment and make possible further progress against inflation. While some Directors expressed understanding of Norway's recent exchange rate actions, others held that in the present external circumstances of Norway--an economy with a large current account surplus--it was, in general, not appropriate to take action to move the nominal exchange rate downward.

Directors noted Norway's generally open trade policy with satisfaction and encouraged further liberalization of imports, especially in the agricultural and textile sectors. They commended Norway for maintaining an exemplary record in foreign aid.

It is expected that the next Article IV consultation with Norway will be concluded not later than July 1986.

3. PERU - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with Peru (SM/84/250, 11/6/84; Cor. 1, 12/11/84; Sup. 1, 12/20/84; and Sup. 1, Cor. 1, 12/20/84). They also had before them a report on recent economic developments in Peru (SM/84/255, 11/19/84).

Mr. Jensen made the following statement:

The Peruvian authorities would like this chair to review and emphasize some aspects related to the 1984 Article IV consultation, which, they feel, are relevant to the formal discussions.

When the newly elected Belaunde Administration took office in late 1980, Peru was suffering from severe structural problems, institutional weaknesses, and a legacy of 15 years of slow growth. While part of the developing world benefited from external environments favorable to economic growth during the 1970s, Peru's economic foundations were being dismantled. Two successive military governments followed policies aimed at expanding the role of the state. Not only did the Government intervene in virtually all aspects of economic activity, but a sweeping land reform and nationalization of productive--particularly mining and energy--and commercial activities led the state into major direct productive activities. New state enterprises--155 of them--were established, and large infrastructure projects were also undertaken; consequently, military procurement increased significantly to the extent that present external debt servicing is still substantially affected by those actions.

The present Government undertook many structural and sectoral reforms. The pricing policies of many state enterprises were quickly improved. Prices of petroleum products, electricity, and many foodstuffs were raised close to world levels by early 1983; many price controls that affected smaller state firms were dropped. Average petroleum prices were doubled to $0.80 per gallon, and have since been increasing gradually. By 1984, virtually all general food subsidies had been phased out; in 1980 they had accounted for 3 percent of GDP. A decision was taken to sell or close many state enterprises. In fact, the later recession and poor status of those companies made sales difficult; some were indeed closed, while those remaining were given greater financial autonomy and responsibility. Major changes in the pricing, trade, and tax policies affecting agriculture and industry were introduced to make them more efficient, employment-intensive, and export-oriented. Agriculture marketing was reopened to the private sector. By the end of 1983, great progress had been achieved in import liberalization: prohibition had been virtually eliminated, and 13 percent of imports were subject to tariffs of up to 10 percent, about half to tariff

rates ranging from 11 percent to 30 percent, and only 20 percent to tariffs above 50 percent. The dispersion of effective protection among subsectors and products was greatly reduced, providing more even incentives across sectors and helping to achieve a more efficient allocation of resources. In spite of a later 15 percent flat increase of all tariffs to raise fiscal revenues, the average effective protection affecting industry has fallen by 50 percentage points since early 1980.

At the same time, the authorities addressed key macroeconomic policy issues with boldness. Peru had often suffered from significant negative real interest rates, an overvalued currency, and a monetary system held hostage to the financing implications of lack of discipline in fiscal policy. Steady increases in interest rates--by 1981, the major effective deposit rate was equal to the inflation rate--combined with a controlled fiscal deficit and a continued accelerated compensatory depreciation of the exchange rate were to set the stage for the growth expected from the many sectoral and structural improvements under way. The output and income response to all of these reforms was expected to be substantial. In fact, the world recession, which began shortly after the new Government took office, and the shift of the warmer "Corriente del Niño" in 1983 combined to devastate Peru's climate and economy: while GDP growth was almost 4 percent in 1980-81, it was almost nil in 1982.

In 1983, everything wenty wrong for Peru. The important anchovy catch completely disappeared as a result of the shifting current. Unremitting rains flooded coastal areas, destroying crops, and temporarily closing the pipeline from the oil producing areas. Frequent landslides disrupted mining and interrupted transport and commerce with the mountain areas. At the same time, the southern Puno area suffered unprecedented drought. Peru's terms of trade turned severely against it; export prices are not only depressed, they are--with the exception of petroleum--lower in real terms than any time since the 1930s. Exports of copper, which usually account for one fifth of Peru's exports, are particularly depressed; the present price for copper is 20-30 percent below the lowest real price for each decade since the 1930s. Real sugar prices are also low. Overall, the import purchasing power of Peruvian exports was 40 percent lower in 1983 than in 1980. Finally, increased terrorism led to higher defense outlays and a deteriorating investment climate. Higher dollar interest rates, and the drop in Andean Group export markets also led to major drops in manufactured goods output, which account for 44 percent of the fall--by 12 percent--in GDP that year. Climatic disturbances also contributed to accelerating inflation, as food prices rose with the adverse crops and transport interruption. By midyear prices were rising at an annual rate of 150 percent, real wages and salaries had fallen by 15-20 percent, tax collections

were falling even faster than real income, and external resources were limited. It was therefore not surprising that critical financial difficulties arose with the fiscal accounts. Revenues, which had shown little elasticity to a growing economy, proved quite elastic to a falling one as the private sector replaced hard-to-find and expensive bank credit with cheap government money (unpaid taxes). Central government receipts fell by 29 percent in real terms, almost three times faster than GDP. As a result, tax revenues, which had traditionally been 20 percent of GDP, fell to 14 percent of GDP. Public investment was cut by 15 percent in real terms--but the deficit of all executing agencies rose rapidly. When new foreign funds were not forthcoming as the targets for the extended arrangement with the Fund were not met, the Government turned to the Central Bank for accommodation. Two thirds of the deficit was financed through the banking system, which meant--given the inability to capture increased financial savings from the declining GDP--net Central Bank credit creation with the consequent crowding-out of the private sector.

In spite of such a hostile and critical economic and financial environment, Peru reaffirmed its commitment to pursuing the adjustment program. When the three-year extended arrangement entered into in mid-1982 ran into serious difficulties toward the end of 1983 it was canceled; in April 1984, an 18-month stand-by arrangement with the Fund was approved. (Peru made five purchases under the extended Fund facility, amounting to SDR 256 million of the total programmed SDR 650 million.) This program sought to maintain the level of net international reserves through the pursuit of a flexible exchange rate and a tight monetary policy, to lower inflation from an annual rate of 100 percent in the first part of 1984 to approximately one half that rate by the latter part of 1984, and to reduce the public sector's overall deficit to 4.1 percent of GDP compared with 11.7 percent in 1983.

As the staff report notes, the overperformance of about $300 million in the level of international reserves in the first half of 1984 was mainly due to the maintenance of a tighter credit policy than programmed by the Central Bank. The balance of payments for that period registered an overall surplus of $84 million, compared with a programmed deficit of $227 million. Remarkable overperformance continues in the trade balance and current account, which are stronger than originally programmed. The exchange rate policy has also been enhanced. Through September, the exchange rate continued to be devalued at a rate of about 10 percent yearly in real terms. Moreover, the daily devaluation rate was doubled some weeks ago. As a result, by September 1984 the trade balance was running a surplus of nearly $800 million, or more than double the programmed amount. A partial reversal of this trend is projected by year-end, but

nevertheless an overperformance of $377 million is expected. Thus, a major improvement of a similar magnitude will also be recorded in the current account.

Monetary policy has continued to be tighter than programmed, with overperformance so far running at the same level as through midyear. In addition, as a result of a net decline in the domestic indebtedness of the nonfinancial public sector, domestic credit expansion has been entirely used by the private sector. Although the growth of credit flows to the private sector remained below the inflation rate through July, they have since steadily grown in real terms. On the other hand, public demand for financial assets continues to fall in real terms, and the velocity of money has increased. Worried by this, the Peruvian authorities continue to provide all the necessary tools for the market interest rates to near and even surpass inflation rates. Since December 15, 1984 they have further increased all nominal rates by 10 percent, which provides wider margins for the effective rate to rise even higher.

Inflation continues at a rate virtually unprecedented in Peruvian history. The causes for this are complex. Increased inflation during 1980-81 was caused mostly by the public sector deficit and an accommodating monetary policy. Since then, an element of cost-push inflation has been having its effects, and it has not been labor costs, as they have decreased significantly in real terms. The main elements probably stem from two policy decisions crucial to the balance of payments and fiscal performance. The compensatory accelerated devaluation, vital to Peru's medium-term prospects, has a greater effect on prices than the traditional import component ratio would suggest. A widely held financial savings instrument denominated in dollars has a significant indexation element throughout the domestic economy. Thus, devaluaton of the sol at a higher rate than inflation, exerts a pervasive effect on the price front. Added to that are the efforts to increase operational revenues of certain public enterprises, which also serves to boost controlled prices over and above inflation. As a result, the consumer price index in the first half of 1984 rose by 48 percent, or about 10 percentage points more than projected. Through November 1984, inflation stood at 96 percent, compared with a programmed rate of 70 percent, the 1983 inflation rate having been 125 percent.

Public finances have been a key element of the program, which has caused Peru great difficulties, not only because of its size, but also because of its sociopolicical implications. In accordance with the policy understanding of the stand-by arrangement with the Fund, the Peruvian authorities undertook additional efforts early this year to recover fiscal revenues. During the first quarter of 1984, a number of adjustment measures

were adopted. Specific taxes were imposed to raise revenues by about 2 percent of GDP for the whole fiscal year, and, at the same time, operational revenues of a number of public enterprises were boosted through increases in controlled prices. The average price of a gallon of low-octane regular gasoline was raised to the equivalent of $1.10 in March of 1984, but has then gradually slipped to below $1. Despite these measures, central government revenue performance so far has been below expectations, showing no elasticity to higher rates after proving quite elastic to falls in output. As of June 1984, revenues were running at 15.1 percent of GDP and are expected to reach 15.5 percent of GDP by year-end--still well below the traditional 20 percent of GDP in recent years. The Peruvian authorities are eager to implement the recommendations that current Fund assistance will provide in this important area.

The Peruvian authorities also adopted further measures to reduce the overall level of expenditures, which, coupled with the expected recovery in revenues, would drastically reduce the fiscal deficit by about two thirds for the year--down to 4.1 percent of GDP compared with 11.7 percent of GDP for 1983. Considerable success was achieved by mid-year 1984. Central government current expenditures were down to 15.2 percent of GDP, compared with 18 percent of GDP for the same period in the previous year and 19.2 percent of GDP for the whole of 1983. Reductions of 0.6 percent of GDP in wages and salaries and 2.4 percent of GDP in military expenditures are particularly noteworthy. Major efforts were also made to cut public investment, although some nonprogrammed project execution continued, if at a slower pace. Still, total investment was down to 7.7 percent of GDP, compared with more than 9 percent of GDP, on average, for the two previous years. The end result of those efforts was a fiscal deficit for the first half of 1984 of slightly over 5 percent of GDP, which compares favorably with the 6.6 percent of GDP for the same period in 1983, and with an average of about 10 percent for the three previous years.

Efforts to contain the fiscal imbalance at lower levels than those achieved through midyear became more difficult, as the control of public outlays has worsened and revenues have not recovered significantly. In addition, the Government has had to give increased attention to smoldering terrorism. Understandably, it is devoting increased resources to restraining the more frequent attempts to destroy human life, productive assets, and democracy itself. Currently about 2 percent of annual GDP is being spend on fighting such an unconventional war. As a result, the financing requirements of the public sector for calendar year 1984 are estimated to be running about 3 percentage points of GDP higher than at midyear. Formal external financing continues at the programmed level of about 5 percent of GDP. As the staff notes, beginning in late July the cash shortage in the Central

Government became acute. The Government, in recognition of the monetary targets and the protection of the balance of payments policy, decided not to have recourse to Central Bank credit, and, as a result, external arrears in the interest payments of the official external debt accumulated. Through end-1984, such accumulation could reach about 2 percent of GDP. In this regard, the Peruvian authorities wish to stress that the only reason for these arrears is the shortage of domestic resources. The Central Reserve Bank has been and is making available the foreign exchange necessary for payment of the external debt whenever it receives the counterpart in local currency.

The authorities are most concerned and aware that the arrears in external interest payments are jeopardizing the 1984-85 refinancing plan. In early 1984, the commercial banks agreed to reschedule $610 million of amortization due to them from medium-term loans between March 1984 and July 1985. Short-term working capital loans amounting to $945 million were also to be rescheduled, and short-term trade-related credits amounting to $900 million were to be frozen. These actions greatly reduce Peru's debt servicing capability. In addition to experiencing cash shortages, the Central Government was increasingly burdened with a large part of the publicly guaranteed debt as a major state enterprise became insolvent. Specifically, the electric power company (ELECTROPERU), which is responsible for more than 90 percent of the deficit for all the nonfinancial public sector enterprises combined, lacks the domestic currency necessary to meet its external debt servicing obligations. It must be noted that ELECTROPERU has been the target of systematic terrorist attacks in the past and has had to devote resources equivalent to about 1 percent of GDP just to replace and repair power stations and plants.

General elections are scheduled for April 1985. All political parties have entered into a full-time pre-electoral campaign, which has resulted in the Government's losing the support of its partner in a congressional coalition, the Christian Party. The latter's support was vital for a weak, but potential majority. The Government now faces a hostile and very strong parliamentary opposition, considerably restricting what it can do on its own initiative, it needs legislation to enact substantive revenue and expenditure measures. The Government, conscious of the need for further adjustment, is willing to sacrifice electoral popularity and is submitting major adjustment measures to Parliament. Under these limitations, the Peruvian authorities' attention is concentrated on addressing short-term economic measures in an environment of significant social tensions. Among these measures, priority has been given to limiting the fiscal deficit, continuing the monetary and exchange rate policies to protect the balance of payments and enhance Peru's export sector, and establishing the basis for the conclusion of the 1984-85 refinancing agreement.

On December 14, 1984 Congress's partial approval of the official proposals so far enables the Government to act on the following:

(a) Prices of all petroleum products will be increased by more than 35 percent; the average price of a gallon of low-octane regular gasoline can now increase to the equivalent of $1.25, from $0.92 per gallon at present. This increase alone represents additional revenues of about 1.6 percent of GDP on a yearly basis.

(b) An across-the-board increase of 3 percentage points in the general sales tax, of which 1 percentage point will be for local governments, will be implemented. This increase, together with increases in other selective taxes, could yield an additional 1 percent of GDP.

(c) The investment program of the Central Government will be contained to a maximum of 2.1 percent of GDP for 1985, resulting in a cut of 1.2 percent of GDP compared with the 1984 results.

In that context, a high-level official mission recently held conversations with both the IMF and the banking community. Peru has requested the Fund to assess the impact of the recent measures in order to lay the foundations needed to re-establish assistance for the adjustment program. With the commercial banks, Peru is proposing a mechanism to bring all external arrears up to date, request the reinstitution of the original committed trade-related lines of credit, and pursue the formal finalization of the 1984-85 financing.

Extending his remarks, Mr. Jensen confirmed the authorities' intention to continue the policy of frequent exchange rate adjustments. In addition, on December 17, the sol had been further devalued by 2 percentage points, and the Central Reserve Bank had indicated that morning that an additional 2 percent devaluation would take place over the weekend. The December devaluation would therefore be equivalent to approximately four times the expected inflation rate for the month.

Mr. Robalino expressed general agreement with the main conclusions of the staff appraisal. Natural catastrophes and terrorism had had a severe effect on the Peruvian economy in 1983. Growth of real GDP, which had initially been estimated at 0.5 percent and had been revised to minus 10.6 percent at the time of the 1983 Article IV consultation, had turned out to be still one percentage point lower.

The figures presented in the medium-term scenario were not optimistic and gave the impression that a sustainable balance of payments position was not foreseeable in the near future, Mr. Robalino continued. The scenario did not, however, specify its assumptions, nor did it address

the questions of interest rate levels, commodity prices, or the attitude of the country's trading partners regarding protectionism. In his opinion, the scenario had projected the economic features of a recent, particularly unusual situation into the future.

He welcomed the measures taken by the Peruvian authorities to restore the competitiveness of the sol, which was now subject to frequent small changes in line with the rate of domestic inflation, Mr. Robalino noted: the so-called real effective exchange rate was, at present, in line with that prevailing four years previously. He also welcomed the latest measures taken by the authorities, as reported by Mr. Jensen. Peru should continue its endeavors to maintain the competitiveness of the sol.

He agreed with the authorities that a reform of the tax structure was urgently needed, particularly as the value-added tax had been substantially reduced, Mr. Robalino remarked. Although additional measures had been taken to improve the nonfinancial sector and reduce the fiscal deficit in 1985, he was concerned that measures approved by the Congress would not be sufficient to bring the fiscal deficit to a point that was consistent with a sound balance of payments position. Additional measures should be taken to contain revenue, as well as expenditure, in order to tackle Peru's most important economic problem, the fiscal deficit. He hoped that the recent Fund technical assistance mission would be able to draw up a comprehensive tax reform that would help to improve the tax system's ability to cope with fluctuations in international prices and meet the needs of fiscal equilibrium.

Some interest rate liberalization had recently been undertaken, and some financial instruments were now yielding positive results, Mr. Robalino noted. He hoped that a more flexible approach toward interest rates would continue in the future. The buildup of external payments arrears was adversely affecting Peru's creditworthiness: unless Peru took strong measures to deal with the economic pressures responsible for those arrears, its future financial situation would become more difficult, and the adjustment effort would have to be even greater. Finally, Peru did not have a flexible enough system or framework to deal with present employment problems, more should be done to increase labor mobility.

Mr. Taha agreed with the general thrust of the staff's analysis and conclusions. In April 1984, an 18-month stand-by arrangement had been approved by the Board to enable the Peruvian authorities to implement adjustment measures. At that time, the economy had been suffering serious domestic and external imbalances: inflationary pressures had threatened to undermine domestic confidence and had contributed to a deterioration in the external sector and to the buildup of debt service obligations. All performance criteria under that arrangement had been met until the end of June 1984, when the program had gone off track, because the ceiling on public sector indebtedness had been exceeded; in setting that criterion, had the staff made sufficient allowance for unforeseen expenditures arising from factors beyond the authorities' control? The program's targets on net domestic assets of the Central Reserve Bank had been met.

with a large margin, in each of the first three quarters of 1984. In general, it was commendable to overachieve; but he wondered whether in exceeding program targets, some of the credit requirements of the economy had not been met. Moreover, had coordination between fiscal and monetary policy been adequate? He invited the staff to comment.

Although the stand-by arrangement was at present inoperative, Mr. Taha continued, the authorities' determination to continue the adjustment effort was reassuring. Peru should adopt a stabilization program at the earliest possible date in order to continue implementing domestic policies conducive to stability and growth and, at the same time, regain the confidence of creditors and settle its external arrears in an orderly manner. He hoped that the Peruvian authorities would find it possible in the near future to work out an adjustment program that could be supported by the Fund.

Despite difficult circumstances, the Peruvian authorities had made good progress toward reducing inflationary pressures and restoring domestic and external equilibrium, Mr. Taha considered. Clearly, more needed to be done, particularly to strengthen public sector finances. Noting that several new fiscal measures had been included in the 1985 Public Financing Law, he urged the authorities to continue their efforts to improve revenue performance and reduce expenditure growth. On the revenue side, it was essential--despite political constraints--to consider all options, including a gradual increase in the value-added tax. He welcomed the tax reform measures recently initiated by the authorities with Fund technical assistance and hoped that they would make steady progress in that area.

If, for any reason, additional revenue measures were not implemented in the near future, spending cuts would have to bear the brunt of strengthening public finances, Mr. Taha remarked. A staff assessment of possible areas for further reducing current and capital expenditures of the Central Government would be helpful in that connection. The authorities should take great care, however, not to cut expenditures relating to productive investment. Moreover, they would have to make determined efforts to keep wage increases under tight control.

The authorities should seriously consider possible institutional changes to control and monitor the spending of public enterprises, Mr. Taha commented. Measures similar to those recently taken by the Philippines, with the assistance of the World Bank, might be appropriate for strengthening fiscal controls in Peru.

A continued tight credit stance was necessary to reduce inflation further and to build up official net foreign assets, Mr. Taha noted. Appropriate monetary instruments should also be used to mobilize domestic savings. In addition, better coordination between monetary and fiscal policy might be helpful to Peru's adjustment efforts.

In the external sector, the authorities' flexible exchange rate policy should be maintained to facilitate export-led growth, Mr. Taha concluded. A sustainable external payments position was important to

enable Peru to discharge smoothly its external debt obligations. On trade, although liberalization measures had been taken, recent indications were that that welcome trend was being reversed; he encouraged the authorities to continue trade liberalization so as to improve domestic resource allocation and external competitiveness.

Ms. Bush stated that progress in Peru was being severely hampered by economic policy deficiencies and a deteriorating economic situation. Grave weaknesses were apparent in fiscal and exchange rate policy. Without a renewed attack on Peru's fundamental economic problems, longer-term prospects for growth and stability were not encouraging.

Some of the more disturbing problems lay in fiscal management and adjustment, which were also to have been a crucial element in the success of the adjustment program, Ms. Bush continued. The failure to bring the public sector deficit under control through actions on revenues and expenditures was serious in itself, but it had also clearly contributed to the high inflation rate. Although the external accounts had improved, the improvement in the current account deficit of the balance of payments was largely due to delays in public sector imports and to an undesirable shortfall in capital goods imports by the private sector. She hoped that the basis for Peru's current account improvement would shift rapidly toward export gains, rather than import compression.

It was regrettable that the authorities, while recognizing the need for substantial changes in relative prices, did not foresee any substantial change in the exchange rate for the sol, or in Peru's increasingly restrictive trade and payments policies in the near future, Ms. Bush remarked. The recent acceleration in the rate of depreciation was, however, a positive step. Did the additional depreciation mentioned by Mr. Jensen represent a shift in policy?

The accumulation of foreign arrears was seriously eroding Peru's foreign credit rating and jeopardizing future access to foreign credit, Ms. Bush added. Moreover, the medium-term outlook, which assumed the restoration of Peru's 1979 competitive position by the end of 1985, as well as some other favorable developments, suggested that Peru would still end the decade with a ratio of debt to GDP of nearly 80 percent and a debt service ratio of 55 percent.

Over the past four years, the ratio of Peru's public sector deficit to GDP had averaged nearly 10 percent, Ms. Bush observed. For 1984, the deficit would likely exceed the 4.1 percent of GDP target by a substantial amount, owing largely to excess spending in the form of noncentral government investment, central government transfers, interest payments, and overshoots on wages and salaries. Revenue shortfalls--resulting from lagging administered prices and utility rate adjustments, and inadequate tax collections--had also contributed to the unfavorable outcome; clearly, the tax system needed to be simplified. The lack of coordination of the policies of the public enterprises with overall fiscal policy was particularly distressing, as those enterprises had overspent on both current and

capital operations. The lack of central supervision and control over public enterprises appeared to be a major policy weakness. It was regrettable that the public sector deficit would be financed through arrears on foreign debt amounting to 2.3 percent of GDP. However, the Government had recently submitted some additional measures to Congress. She invited the staff to assess the extent to which the new fiscal measures mentioned by Mr. Jensen and reported in SM/84/250, Supplement 1 would contribute to the goal, suggested by the staff, of improving the fiscal position by about 3.5 percent of GDP to avoid payments arrears and to lay the basis for a renewed attack on the deficit in 1985.

Monetary policy was one of the bright spots in the Peruvian economic picture, Ms. Bush considered. The Central Reserve Bank had had some success in restricting total credit, in protecting the private sector's access to credit, in moving toward more market-related and positive real interest rates, and in promoting a more efficient financial system whereby domestic financial institutions could be strengthened and foreign institutions could participate in providing modern financial services. The 10 percent rise in nominal interest rates effective December 15 had been a positive step. She also welcomed the recent increases in bank reserve requirements, which were expected to absorb the bulk of excess bank reserves in soles and dollars. Nonetheless, public confidence in the currency was clearly still weak, as evidenced by the rise in dollar-denominated deposits to nearly 50 percent of the money supply and the outflow of short-term capital, which was expected to reach more than $500 million in 1984.

Peru's trade and payments system gave rise to a number of problems, Ms. Bush remarked. First, intense fiscal pressures had induced the authorities to use import duties and tax increases as sources for short-term revenue, even though such measures were not in keeping with the Government's longer-term goals for the structure of the trade and tax systems. Furthermore, the balance of payments constraint had contributed to growing import restrictions and continued export subsidies, practices that might not be consistent with commitments to the Fund. In addition, the staff's proposed treatment of exchange restrictions after July 31, 1985 was ambiguous because it would, evidently, not involve a definite decision by the Board. She requested clarification of the staff's proposal on page 26 of SM/84/250 that "if final agreements are not in place..., nor are there firm expectations that they will be concluded soon thereafter, those agreements in principle would be deemed to have ceased to be operative and...that approval of the restriction involved would be regarded as discontinued." She agreed that, if by July 31, 1985 final agreements were not in effect or expected, Fund approval should cease.

Peru had used Fund resources for a long time and fit the definition of a prolonged user suggested by the staff, Ms. Bush commented. Although Peru had had six programs in the last ten years and had rather large obligations outstanding to the Fund, its progress on economic adjustment had been disappointing. While she recognized that negative outside factors had impeded adjustment, the Peruvian authorities needed to undertake a stronger effort if they were to achieve economic recovery, domestic

financial stability, and a sustainable balance of payments and foreign debt situation besides receiving the continued cooperation of the international financial community. She hoped that a strong renewed effort would be made in 1985.

Mr. de Vries remarked that, despite the measures taken by the authorities, Peru's economic situation was unsustainable. The budgetary developments summarized in Table 3 of SM/84/250 were central to the problem. In recent years, the overall public deficit had equaled about 10 percent of GDP. In 1980, it had been less than half as much--4.8 percent--and, despite hopes of a substantial reduction in 1984, it was currently estimated to be about 10 percent. The difficulty was clear: expenditures had remained relatively constant in terms of GDP, while revenues had remained substantially lower in terms of GDP. Although the stricter monetary policy in 1984 was encouraging, monetary policy alone was insufficient to rectify the situation, given the fiscal imbalances.

Chart 1 of SM/84/250 showed that the real effective exchange rate had appreciated by over 20 percent since the late 1970s, Mr. de Vries added. Although the measures announced by Mr. Jensen went in the right direction, their magnitude did not seem sufficient to correct the apparent substantial overvaluation of the sol. In the light of unfavorable external circumstances, especially those affecting some exports in the medium term, the Peruvian authorities should give a great deal of attention to exchange rate adjustment.

The ratio between external debt and GDP had risen consistently from 75 percent in 1983 to 81 percent in 1984, and it was projected to rise to almost 100 percent in 1985, Mr. de Vries remarked. That situation was clearly unsustainable. Moreover, the authorities' reliance on external arrears as a means of domestic financing was not only an extremely expensive and counterproductive policy but also an unsustainable one.

When Executive Directors had considered the stand-by arrangement with Peru in April 1984 (EBM/84/67, 4/26/84), he had expressed some doubt about the authorities' commitment to the program, Mr. de Vries recalled. The question remained: why had the authorities been so insistent on having a stand-by arrangement when they did not have the political commitment to carry it out, at least in public finance? Peru had had a series of arrangements with the Fund and, unfortunately, its economic situation remained unsustainable, if not critical. He welcomed Mr. Jensen's statement that the authorities were determined to continue adjustment, as it was clearly needed. In concluding, he agreed with the procedure outlined by the staff concerning continued Fund approval of the exchange restriction.

Mr. Wicks stated that the economic situation in Peru at present was in many respects worse than it had been at the inception of the extended arrangement with the Fund in June 1982. While partly due to the natural disasters of 1983 and the difficult external circumstances, the deterioration had also been due in large part to inadequate policy implementation, also the main cause of the failure of the current stand-by arrangement.

In that regard, he noted in particular the reduction of the value-added tax rate from 18 percent to 8 percent in July 1984 and the failure to control the activities of public enterprises.

Policy implementation was always more difficult when electoral events were pending, Mr. Wicks remarked, although the question was not whether adjustment was to take place, but how adjustment would take place. At the moment, the authorities were getting by largely through running up domestic and external arrears. As a temporary expedient, that practice could do serious damage to Peru's creditworthiness, and it offered no solution in the longer term. The authorities should adopt corrective measures aimed at the sources of the imbalances as soon as possible. To the extent that reforms were delayed, eventual adjustment would have to be the greater. He hoped that negotiations with the Fund for a new stand-by arrangement to replace the existing one could be resumed as soon as possible; any new arrangement should, however, rest soundly on some vigorous prior actions.

He generally agreed with the staff appraisal, Mr. Wicks continued. The sharp decline in public savings in Peru had clearly been due largely to the substantial fall in tax revenues as a percentage of GDP since 1980. Therefore, the reduction in the sales tax in July without effective offsetting measures was disturbing. That change--the third major change in the value-added tax in 1984--placed a considerable extra strain on tax administration, which was already far from satisfactory. Clearly, a well-conceived and conclusive reform of the tax system was urgently needed to reverse the decline in reserves. He would be interested to learn from the staff or from Mr. Jensen whether the recent review of the tax system had yet been completed and, if so, what further action was proposed.

The lack of control over the parastatals, Mr. Wicks went on, was cause for considerable concern; on page 13 of its report, the staff appeared to suggest that the efforts of the Ministry of Economy, Finance, and Commerce to establish control were being frustrated by other government departments. Meanwhile, the public enterprises continued to spend, failed to raise prices appropriately, and financed their operations by running up external arrears. Control over the parastatals needed to be re-established urgently; measures to that effect should be an essential precondition of any future program with the Fund.

Every national treasury or ministry of finance found it difficult to control parastatals, Mr. Wicks observed. The parastatals in his own country, as well as the departments that controlled them, had on occasion argued that the Treasury had nothing to do with them. Parastatals did not turn to a ministry of finance for advice on their investment programs or wage policies, but for money; in that regard, the Peruvian authorities should consider whether their Ministry of Economy, Finance, and Commerce could control the parastatals' demands on the national budget.

He agreed with the staff on the need to restrain wages, Mr. Wicks remarked. The emergence of wage pressures was not surprising, given the decreases in real wages of recent years; that feature of the economy further illustrated the dangers of gradual adjustment.

Despite the use of a number of devices to circumvent the 60 percent limit on sol-denominated nonindexed deposits--notably, paying interest in advance--which had had the effect of considerably complicating the financial system, there were still considerable incentives to hold dollar deposits and increasing signs of a dollarization of the economy, Mr. Wicks noted. He therefore agreed with the staff that emphasis should be placed on a more flexible approach to interest rates, especially to avoid the growing dollarization.

He commended the authorities for having maintained and even slightly improved Peru's external competitiveness, Mr. Wicks added. Nevertheless, the sol still appeared to be overvalued, and he therefore welcomed Mr. Jensen's opening remarks. Considering the difficult medium-term balance of payments prospects, the authorities should carefully consider further action on the exchange rate.

Finally, he shared Ms. Bush's concern about Peru's prolonged use of Fund resources, Mr. Wicks remarked. Executive Directors would have to consider that matter carefully in the near future.

Mr. Hammann shared the concerns expressed by other Directors that Peru had for some time been using Fund resources with disappointing overall results. Whereas the previous extended arrangement had become inoperative partly because of adverse exogenous factors, the most recent stand-by arrangement had certainly failed because of policy slippages. In fact, the slight progress attained in the first quarter of 1984 seemed to have been attributable to prior actions; after the stand-by program had actually become operative, the adjustment effort had not been maintained. He noted with satisfaction the measures which had been communicated in SM/84/250, Supplement 1 and invited the staff to provide a short appraisal of those measures.

As the staff report clearly stated, the proximate causes for the renewed unsatisfactory performance under the stand-by arrangement had been the exploding fiscal imbalance--due to simultaneous overruns in current expenditures and shortfalls in revenues--complemented by apparent weaknesses in wage, external, and monetary policies, Mr. Hammann continued. That policy stance had exacerbated internal as well as external disequilibria and overshadowed the prospects for a prolonged and sustainable resumption of growth and development. The renewed accumulation of internal and external arrears was particularly worrying. All those developments raised doubts about the authorities' commitment to meaningful cooperation with the Fund.

Peru's poor performance under the recent stand-by arrangement had unfortunately justified the skepticism of those Executive Directors who in April had projected a short life expectancy for the program, Mr. Hammann remarked. Any new program must therefore presuppose a substantial amount of prior action. Furthermore, it should be comprehensive, embracing both structural and global demand policies. Finally, in view of Peru's repeated use of Fund resources and its bad track record, a low limit on access to Fund resources seemed to be advisable.

The recent measures taken by the Central Reserve Bank with respect to credit and interest rates, were welcome, Mr. Hammann commented. The policy of not granting credit to the nonfinancial public sector was courageous and should make more financial resources available to the private sector. He questioned, however, whether interest rates were sufficiently high to make domestic financial assets attractive and prevent a further dollarization of the economy. The authorities should give more weight to market forces in determining interest rates.

Tightening monetary policy alone would not be sufficient to reverse deteriorating economic trends, Mr. Hammann considered. A strengthening of the public finances was not feasible unless the authorities simultaneously enhanced revenues, contained expenditures, and placed the public enterprises under the strict supervision of a single administrative unit, which should control both expenditures and pricing policy. Like Mr. Taha, he commended to the authorities the measures taken by the Philippines in that direction. He also strongly supported the staff's proposal to raise the value-added tax to its previous rate. In his statement, Mr. Jensen had indicated that the administration was now authorized by the Budget Financing Law to raise taxes, including the value-added tax. He wondered whether decisions in that regard had already been taken. He also noted that the income tax/GDP ratio, very low by international standards, had decreased further and could provide ample room for maneuver in the future.

Peru's highly expansionary incomes policy had also contributed to the failure of the stand-by arrangement, Mr. Hammann stated. Future wage increases should be contained, although due regard should be paid to the efficient functioning of the civil service and to certain social aspects.

The efficiency of the labor market in Peru suffered from labor legislation rigidities similar to those prevailing in more advanced European countries, Mr. Hammann noted. He invited either Mr. Jensen or the staff to comment on whether the authorities had plans for a renewed attempt toward dismantling those rigidities. To what extent might such a dismantling have a beneficial impact on the overall employment situation in Peru?

The increase in import duties and the strong pressure to increase protection were evidence of an overvalued exchange rate, Mr. Hammann observed. Despite commendable action so far, the real effective exchange rate was still substantially above that prevailing in the late 1970s. A flexible exchange rate policy could help to counter protectionist pressures

and allow some room for reducing or removing import controls and high import duties, it would also have a beneficial impact on the efficiency and productivity of Peru's economy. He noted with concern the recently enacted total prohibition of certain import commodities.

In view of Peru's high external indebtedness, the accumulation of arrears, and the need to come to an agreement with its foreign creditors, the authorities would be well advised to persevere in their efforts to resume adjustment, Mr. Hammann concluded. Peru faced serious internal problems, but there seemed to be no viable alternative to adjustment.

Mr. Pickering stated that the disappointing performance of the Peruvian economy in 1984 reflected some important external developments, but slippages in the implementation of sound economic policies had also been an important factor. A most worrisome feature of the Peruvian economy was that, if current policy continued, the situation would further deteriorate over the coming months and years.

Policy slippages were nowhere more apparent than in the fiscal area, where the authorities had experienced persistent difficulties in bringing the budget under control, Mr. Pickering continued. Regrettably, descretionary changes in spending had played a key role in the large public sector deficit. The increase in arrears, both domestic and external, and the high rate of inflation associated with the large fiscal deficit would further reduce the already low confidence of Peru's creditors and impair the attainment of growth and employment objectives. While he recognized that the authorities' ability to assume a more restrictive fiscal stance was limited by social and political conditions, the economic developments resulting from maintaining inappropriate policies could in themselves give rise to growing social tensions.

The authorities should implement comprehensive measures to contain public sector expenditures, increase revenues, and strengthen the financial position of the public enterprises, Mr. Pickering considered. He welcomed the general review of the tax structure undertaken earlier in 1984 and supported the staff's emphasis on the need to improve tax administration. Increasing revenues, however, took time; recently, efforts to maintain revenue had been contributing to increased trade distortions and tax evasion. In reducing the deficit, priority should therefore be given to greater containment of expenditures over the short term, including control over wage increases and greater flexibility in public pricing policy.

As Mr. Wicks had noted, much of the fiscal problem continued to be the decentralized control over the activities of public enterprises, which contributed to uneconomical expenditure programs and inflexible prices, Mr. Pickering remarked. Unfortunately, efforts to strengthen central administration control over those enterprises had not been successful so far, and he urged the authorities to renew ther efforts to improve the situation.

He welcomed the maintenance of a tight credit policy, Mr. Pickering went on. Monetary policy had borne too large a share of the burden of adjustment. The authorities had continued to maintain a ceiling on interest rates on nonindexed savings instruments--which accounted for the bulk of sol-denominated private sector financial assets--that was below the rate of inflation, a practice that had contributed to the low rate of domestic savings and had exacerbated the trend toward the dollarization of the economy. Although the ceiling had recently been raised marginally, there was still room for greater flexibility in setting interest rates.

The substantial increase in import duties and the introduction of licensing requirements on selected imports were regrettable, Mr. Pickering commented. Increases in tariffs to about 56 percent had been implemented as part of the attempt to maintain public sector revenues. The average unweighted tariff was, however, less than 56 percent, and, according to the authorities, evasion was increasing. Moreover, the increase in import barriers as a result of tariff increases and, to a lesser extent, the licensing requirement would have an adverse impact on Peru's trading partners and risked inviting retaliatory measures. In addition, he reiterated the concerns that his chair had expressed in the past about the trade and financial implications of subsidies for nontraditional exports.

The exchange rate policy currently being pursued had permitted the exchange rate to depreciate in real effective terms, Mr. Pickering noted with satisfaction. In view of the continued deterioration in the external balance, the increase in trade barriers, and the widening divergence between the official and parallel exchange rates, however, the present exchange rate appeared to be inappropriate, and a faster rate of depreciation might be warranted. He would appreciate comment from the staff on that point.

The medium-term outlook was uncertain, Mr. Pickering observed. The projections suggested that the debt service ratio would stay high and that the economy would remain vulnerable to trade developments even if a modest adjustment program were implemented immediately. That situation was worrying, as Peru had obtained 21 stand-by arrangements with the Fund to date, and over the past eight years had had 5 stand-by arrangements and an extended arrangement originally designed for a period of three years. Although external factors had exacerbated Peru's economic difficulties, inadequate control over domestic economic and financial policies in recent years had played an important role in Peru's poor economic performance. Mr. Jensen had stated that Peru had requested the Fund to assess the impact of the recent measures in order to lay the foundations needed to re-establish assistance on the adjustment program. It was difficult, however, to imagine how the Fund might continue to help Peru at the present stage. Financial assistance had been prolonged and had remained generally high; technical assistance had been frequent and comprehensive; and, more important, the authorities' record in pursuing the type of adjustment that the Board expected from its members had been poor, particularly during the current program. In view of those considerations, the Fund's future role must be carefully measured.

The Peruvian authorities should adopt a major economic adjustment program at an early date, Mr. Pickering urged. The recently introduced 1985 budget provided some reason for optimism, but more measures were clearly required. He hoped that the general election in April 1985 would provide a new Government with the political mandate necessary to improve the economic situation. Within its sphere of expertise, and within its current procedures for establishing arrangements, the Fund should stand ready to help Peru.

Mr. Pérez stated that it was evident, both from Mr. Jensen's opening statement and from the staff report, that Peru had had more than its share of misfortunes. In addition to the external shocks that had afflicted most developing countries, Peru had had to cope with major natural disasters and a vicious internal struggle. Copper exports had been severely affected by the lowest real prices in five decades. Internal struggles had placed enormous demands on both revenues and expenditures. Furthermore, the "Corriente El Niño" had practically destroyed the remaining fishing industry and at the same time had brought drastic climatic changes that had resulted in floods and drought.

Although those events had been mentioned by the staff, Mr. Pérez continued, the overall impression left by the staff papers was that the authorities had not undertaken a sufficient adjustment effort aimed at correcting the serious imbalances of the economy produced by both external shocks and economic mismanagement. That impression should be qualified.

The staff had placed particular emphasis on the significant fall in fiscal revenues, from about 20 percent of GDP in 1980 to about 14 percent in 1983, Mr. Pérez noted. However, the authorities' efforts to increase fiscal revenues had to be placed in their proper context. A deterioration in economic conditions of the magnitude suffered by Peru would normally be reflected in a fall of fiscal revenues even measured as a ratio of GDP. Since Peru's tax system depended heavily on foreign-trade-related revenues, the severe contraction of both exports and imports--by more than 5 percentage points of GDP from 1980 to 1984--had resulted in a significant fall in revenues. Moreover, while a progressive income tax structure would normally be expected to yield decreasing revenues as income dropped, the general deterioration of economic conditions naturally led to greater tax evasion both by individuals and firms. A tight monetary policy stance had, on the other hand, resulted in firms' using taxes owed to the Government, in lieu of credit, as working capital. Another feature of the contraction of economic activity was that a number of transactions that had formerly taken place in the "registered" market economy were now effected in the "underground" or "unregistered" economy, on which taxes were not collected.

Although projected revenues would fall short of the program targets by almost 1 percentage point of GDP, the declining trend had been reversed, and expected revenues for 1984 would exceed those of 1983 by 0.8 percentage point of GDP, Mr. Pérez added. The staff's concern about the Government's revenue structure and performance was fully justified, but the special

circumstances of the country indicated that tax rate increases might not be the most appropriate course of action. The Fund had recently provided technical assistance in relation to the tax system, and he would be interested to hear the staff's comments on the conclusions reached by the mission and the perceived scope for structural reforms, which might indicate alternative means of strengthening public sector revenues.

The demand placed on expenditures both by the internal struggle and by the need to repair the damage done to the infrastructure by the disasters of 1983 were indeed onerous, Mr. Pérez remarked. Nevertheless, the authorities had undertaken measures to reduce food subsidies, increase gasoline prices, and close or sell inefficient state enterprises. The policy actions oriented toward implementing structural reforms in the agricultural sector, domestic pricing mechanisms, and import liberalization were encouraging. Nevertheless, he remained concerned about the apparent lack of coordination between the Central Government's budget and those of the state enterprises. Greater efforts should be directed toward rationalizing current and capital expenditures of public sector firms, a task that would be greatly facilitated by the creation of coordinating mechanisms that would place expenditure and pricing policies under the close supervision of the central authorities.

The authorities had courageously taken a firm stance against automatically financing any public sector imbalances, Mr. Pérez considered. Although the accumulation of external and internal payments arrears was an undesirable by-product of those tight credit policies, the signals given by the Central Reserve Bank to the private sector were clearly positive. The structure of Peru's financial system required that confidence in a strong monetary authority be maintained. In that respect, the strong trend toward dollarization that had recently occurred in the Peruvian system was of great concern. Dollar-denominated deposits constituted more than 50 percent of time deposits held in Peruvian banks, and their share was increasing over time. According to staff estimates, the amount of those deposits was roughly equivalent to the current international reserves of the Central Reserve Bank. If the present trend continued, dollar deposits could easily surpass the value of foreign exchange reserves, which would seriously undermine the confidence of deposit holders. The possibility of a run on deposits would then become much more serious. He inquired whether the monetary authorities were contemplating a more consistent policy combination affecting both interest rates and the exchange rate or other measures to prevent a further relative accumulation of dollar deposits.

The Board should take into account the adverse conditions faced by the Peruvian economy when assessing its performance under the stand-by arrangement, Mr. Pérez concluded. He urged continued close cooperation between the Fund and the authorities, based on more realistic goals than those envisaged in Peru's previous programs with the Fund.

Mr. Vasudevan remarked that both the staff report and Mr. Jensen's opening statement attested to Peru's difficult economic position. The growth of GDP in 1984 was expected to be lower than originally projected. At its present level, real GDP would be lower than in 1980, and real wages would be lower than they had been five years earlier. Consequently, Peru's savings and investment rates had declined over the years. Meanwhile, the rise in nominal expenditures had led to inflation rates "virtually unprecedented in Peruvian history," as Mr. Jensen had pointed out. Large deficits of the public sector, financed largely by foreign borrowing, had led to the growth of external public debt. Monetary expansion had been too high in recent years, although in 1984 the authorities had done well to keep the growth in net domestic assets of the banking system in check. The medium-term outlook to the end of the 1980s pointed to the need for debt restructuring arrangements with Peru's principal foreign creditors to reduce amortization payment to manageable levels.

The key to a workable program for Peru lay in the management of public finances, Mr. Vasudevan considered. Although the initial efforts to raise tax revenues in early 1984 had been a step in the right direction, they could not be sustained in the present circumstances. The various measures provided for in the 1985 Budget Financing Law could, however, be expected to yield a significant increase in revenues and to raise prices of oil derivatives. In that regard, he would be interested in learning more about the liquidity effect of the deficit financing implied in the requirement that wage earners should purchase development bonds up to a certain percentage of their earnings. The authorities should implement all the measures envisaged in the 1985 Budget Financing Law so that a satisfactory fiscal plan could be developed. He hoped that technical assistance from the Fund would provide a measure of improvement in Peru's fiscal position.

The tight credit policy of the Central Reserve Bank was heartening, Mr. Vasudevan added. The measures taken in mid-December 1984 to raise legal reserve requirements and interest rates were also welcome and showed the necessary flexibility.

The Government's exchange rate policy had also been fairly flexible and had provided a measure of protection to the balance of payments, even though there had been some delay in imports, Mr. Vasudevan remarked. Net international reserves of the Central Reserve Bank had exceeded the program target by $340 million by the end of November; that was encouraging, but the Central Administration had also accumulated considerable arrears with foreign creditors, which could affect Peru's access to capital markets.

In SM/84/250, the staff had observed that the benchmark for the emergence of a multiple currency practice was a 2 percent spread between the official exchange rate and the dollar certificate market rate, Mr. Vasudevan observed. In SM/84/250, Supplement 1, the staff stated that that spread had recently been narrowed "to about 2 percent." Was he correct in assuming that at present no multiple currency practice existed?

The assumptions on which the medium-term outlook had been based required closer examination, Mr. Vasudevan commented. For example, the assumption that Peru's international competitiveness would be restored to the 1979 level by the beginning of 1985 was dependent upon circumstances apparently beyond the authorities' control. Indeed, recent trends in copper and sugar prices, growing protectionism, and uncertainties regarding fishing prospects did not augur well. As noted on page 23 of SM/84/250, the Peruvian officials had clearly recognized that "a return to economic growth in a framework of financial stability would require a strengthening of the public finances, and an improvement in the current account of the balance of payments through an adjustment of relative prices." The approval of the 1985 Budget Financing Law in December 1984 had thus represented a step in the desired direction. Given the magnitude of external arrears, the authorities would have to undertake considerable adjustment efforts in both fiscal and monetary policy, and also take measures affecting wages and prices that would lead to efficiency in resource allocation. He expressed the hope that the positive policy developments that had taken place in December would help Peru to restructure its debts and would encourage its creditors to view Peru's problems with a measure of understanding.

Mr. Coumbis asked, first, whether it was possible to control the development of the dollarization of the economy in a country like Peru with so many problems and such a high inflation rate. Second, what effect did the dollarization have on inflation, since Mr. Jensen's statement had suggested that there was a possible vicious cycle between the two?

Mr. Chen stated that the performance of the Peruvian economy had been basically on track during the first half of 1984. The current account had improved, monetary policy had been quite tight as programmed, and there had been reductions in major components of government expenditure compared with 1983. But, owing to several factors--some beyond the authorities' control--slippages on the fiscal front had widened by the end of June, and the arrangement had been interrupted. Nevertheless, the Peruvian authorities had not abandoned their adjustment effort. In particular, the recent measures introduced in the framework of the adjustment program were especially praiseworthy because they had been made at a difficult time, which testified to the authorities' determination to achieve a turnaround in the economy.

Apart from the fiscal slippages, all the performance criteria had been met at the time of the interruption of the stand-by arrangement, Mr. Chen continued. Therefore, he agreed with the staff that further adjustment was essential on the fiscal front. In retrospect, however, he noted that the budget deficit had been programmed to fall from 11.7 percent of GDP in 1983 to 4.1 percent in 1984, a reduction of about two thirds within one year. Furthermore, GDP had declined by about 12 percent in 1983 and was projected to recover only moderately in 1984. Thus, the authorities faced a narrowed taxable base. On the other hand, there were rigidities in some of the major components of budget expenditure, which would not have lent themselves to big cuts in the short run. Therefore,

perhaps the original program target had been overambitious. In making that observation, he had in mind not only possible future discussions between the Fund and the Peruvian authorities, but also a general desire to avoid too many interruptions in future Fund programs.

According to Mr. Jensen's statement, the Fund had been requested to assess Peru's recent economic developments in order to re-establish Fund support for Peru's adjustment program, Mr. Chen recalled. He invited the staff to comment on how the Fund might help the Peruvian authorities to further their adjustment effort at present and on the conditions under which the interrupted arrangement could be revitalized at an early date, as such a revitalization was of importance not only to ensuring the successful implementation of the adjustment program but also to strengthening the confidence of the international community in Peru's creditworthiness.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/84/187 (12/19/84) and EBM/84/188 (12/21/84).

4. APPROVAL OF MINUTES

The minutes of Executive Board Meeting 84/84 are approved. (EBD/84/315, 12/13/84)

Adopted December 19, 1984

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/84/278 (12/18/84) is approved.

APPROVED: October 23, 1985

LEO VAN HOUTVEN
Secretary