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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/10

10:00 a.m., January 12, 1983

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

Executive Directors	Alternate Executive Directors
A. Alfidja	W. B. Tshishimbi
J. Anson	C. Taylor
J. de Groote	H. G. Schneider
	A. Le Lorier
	M. Teijeiro
	C. Dallara
	T. A. Connors, Temporary
M. Finaish	T. Alhaimus
A. H. Habib	Jaafar A.
T. Hirao	T. Yamashita
R. K. Joyce	M. Casey
A. Kafka	C. Robalino
G. Laske	G. Grosche
G. Lovato	
R. N. Malhotra	A. S. Jayawardena
	J. E. Suraisry
	S. El-Khouri, Temporary
J. J. Polak	T. de Vries
	K. G. Morrell
	O. Kabbaj
F. Sangare	E. I. M. Mtei
	J. L. Feito
J. Sigurdsson	L. Vidvei
Zhang Z.	Wang E.

L. Van Houtven, Secretary
L. Collier, Assistant

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Also Present

Asian Department: N. N. Choudhry. European Department: L. A. Whittome, Counsellor and Director; A. Arimo, B. Christensen, P. B. de Fontenay, L. Hansen, P. L. Hedfors, M. Ishihara, A. Knobl, G. F. Kopits, S. Mitra, G. Tyler. Exchange and Trade Relations Department: S. Mookerjee, Deputy Director; D. K. Palmer, Deputy Director; N. Kirmani. External Relations Department: H. P. G. Handy, H. O. Hartmann, G. P. Newman. Fiscal Affairs Department: G. Blöndal. Legal Department: G. P. Nicoletopoulos, Director; W. E. Holder. Middle Eastern Department: S. H. Hitti, Z. Iqbal. Research Department: W. C. Hood, Economic Counsellor and Director; C. F. Schwartz, Associate Director and Director of Adjustment Studies; A. D. Crockett, Deputy Director; H. P. G. Handy. Secretary's Department: J. W. Lang, Jr., Deputy Secretary; A. Wright, Deputy Secretary; A. P. Bhagwat. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer; D. Williams, Deputy Treasurer; K. Boese, D. S. Cutler, T. M. Tran, G. Wittich. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; C. E. Sansón, Deputy Director. Advisors to Executive Directors: S. R. Abiad, J. R. N. Almeida, J. Delgadillo, A. B. Diao, P. Kohnert, I. R. Panday, P. D. Péroz. Assistants to Executive Directors: H. Arias, R. Bernardo, L. E. J. Coene, G. Ercel, I. Fridriksson, G. Gomel, A. Halevi, M. Hull, J. M. Jones, M. J. Kooymans, P. Leeahtam, J. A. K. Munthali, V. K. S. Nair, Y. Okubo, J. G. Pedersen, G. W. K. Pickering, J. Schuijer, D. I. S. Shaw, H. Suzuki, P. Verly, A. Yasseri, A. A. Yousef, Zhang X.

1. REPORT BY MANAGING DIRECTOR

The Managing Director reported that, accompanying the new Chairman of the Interim Committee, Sir Geoffrey Howe, he had visited Saudi Arabia a few days previously. On January 8, discussions with the Saudi Arabian authorities had taken place in two parts: the first concerned the preparations for the Interim Committee meeting; the second concerned the third tranche under the Saudi Arabian Monetary Agency (SAMA) agreement.

Regarding the preparations for the Interim Committee meeting, in-depth and constructive discussions were held with the Minister of Finance and Sir Geoffrey on the different questions to be discussed by the Committee, including quotas--their size, distribution, methods of distribution, and methods of payment. The Saudi Arabian authorities had shown a spirit of responsibility, a commitment to a strong Fund, and a profound desire to help achieve a reasonable and acceptable agreement at the next meeting of the Interim Committee.

Sir Geoffrey had also taken up the question of the expansion of the General Arrangements to Borrow (GAB), and the Saudi Arabian authorities had asked a number of questions regarding the ways in which Saudi Arabia could be associated with the GAB, if they eventually decided to take that course, and the types of parallel arrangement that could be devised. No decision had been taken by the Saudi Arabians on that matter. They were very interested in the idea of a real exchange, and felt that, if asked to associate in one form or another with the GAB, they would wish to be fully informed of the general discussions that took place within the group. Sir Geoffrey, who had not been empowered to discuss any precise formula, took note of the questions and concerns of the Saudi Arabian authorities. It was his intention to bring up the matter at the ministerial meeting of the Group of Ten in Paris on January 18--the matter could also be taken up by the Deputies on January 17--in order to get some reaction from the Group of Ten on the question in the hope that, following the ministerial meeting in Paris, it would be possible to continue the dialogue with the Saudi Arabian authorities on suitable procedures.

On the question of the third tranche of the SAMA loan to the Fund, the Managing Director said that he had had a separate meeting in the afternoon with Minister Abal-Khail and the Governor of the Saudi Arabian Monetary Agency, Mr. Al-Quraishi, describing the Fund's liquidity position in the light of the large programs that were contemplated, as well as the agreement recently reached with Mexico. He had explained the possibility of a growing commitment gap in the coming months, possibly of the order of SDR 3.5 billion by the end of April. He therefore had asked the Saudi Arabian authorities to consider the third tranche question with the maximum support. The Saudi Arabian authorities had played a fundamental role in enabling the Fund to respond to the difficult situation that had emerged since the summer. It was clear that without the Saudi Arabian loan the Fund would not have had a 450 per cent policy, or else that the Fund would have had to change its financing methods completely. The

Saudi Arabian authorities had played a major role in bolstering the Fund's resources, as it turned out only a few months before a real test of the system had arisen, and it was hoped that the spirit of cooperation would continue in their consideration of the third tranche. The authorities had not given an answer at that time, as they wished to see how the overall picture would develop regarding their own budgetary side at a time when things had become more difficult for them because of developments in the oil markets and also in relation to the other parts of the negotiations. They had said that they would do their best to give their position before the Interim Committee meeting. The discussions had been conducted in a spirit of friendliness, openness, and awareness of the problems. The authorities had been extremely well informed on every aspect of the discussions, and their evident desire to strengthen the system through the Fund was exemplary.

Following those discussions, the Managing Director continued, he had returned to London with Sir Geoffrey, who, in view of the soundings that he had made, the progress that had been reported on the discussions in the Board, and the reactions of some colleagues in the Interim Committee, had reached the conclusion that it would be advisable to convene the Interim Committee earlier than the end of April, the date that had been agreed upon at the Toronto meeting. Therefore, he had been asked to tell the Board that Sir Geoffrey would send a telex to his colleagues in the Interim Committee that day to propose a meeting of the Committee in Washington on February 10 and 11. Mr. Van Houtven would be in touch with Sir Geoffrey's secretariat to ensure that the telex proposing those dates would be sent that day. The question of the agenda would have to be taken up in the Board as usual, and in view of the time constraint, there should be a discussion on the proposed agenda Friday, January 14, to which Sir Geoffrey had agreed.

On his return journey, the Managing Director concluded, he had stopped for one day in Paris, where he had had a long and useful talk with Mr. Jacques Delors, Minister of Economy and Finance and Chairman of the Group of Ten, and Mr. Camdessus, Director of the Treasury. He had reported those latest developments, and they had discussed the best way of conducting the meeting of the Group of Ten in light of the present information.

The Executive Directors took note of the report of the Managing Director.

2. TURKEY - STAND-BY ARRANGEMENT - WAIVER AND MODIFICATION OF PERFORMANCE CRITERIA

The Executive Directors considered a request by Turkey for a waiver and modification of performance criteria under the current stand-by arrangement (EBS/82/230, 12/13/82; and Sup. 1, 1/4/83).

Mr. de Groote commented that his initial reaction had been that, as the case before the Board did not raise any issue of substance, it was not necessary to circulate a written statement. However, he had recently received many questions from his colleagues about the precise meaning of the proposed decision and the specific obligation to which the waivers referred. The large differences between the proposed decision in EBS/82/230 and the version submitted in Supplement 1 might have given rise to misunderstandings; he therefore wished to make three observations.

First, Mr. de Groote said, the drawing that would become possible if the two waivers were granted at the present meeting had originally been intended to take place at the end of October. The Kastelli Bank crisis had made it impossible to observe the performance criterion in the July-September quarter relating to the reserve requirements of the banking system. A waiver was therefore needed to permit the drawing of the amount originally scheduled for the end of October 1982. Additional measures had already been taken by the authorities to mop up the liquidity that had not been absorbed through the operation of reserve requirements. To ensure the observance of that criterion in the future, a new system of reserve requirements had been introduced, which was simpler because it employed a uniform reserve ratio, and more effective because it monitored the liquidity ratios on an average daily basis rather than once a month.

Second, Mr. de Groote continued, the continuous overperformance of the balance of payments had generated more liquidity than had been foreseen, which had not been offset by compensatory liquidity reduction by the Central Bank owing to the absence of appropriate policy instruments. The performance clauses relating to net domestic assets of the Central Bank had, therefore, to be made stricter in order to absorb in the fourth-quarter part of the excess liquidity creation that had taken place in the third quarter, so that for the year as a whole liquidity creation would be brought back in line with the objectives of the program. However, since the criteria relating to credit to the public sector for end-September had been observed, because excess liquidity creation had been due only to balance of payments reasons, no waiver was legally required on that point for the present drawing. A change was however needed in the performance criterion on the Central Bank's net domestic assets to be absorbed during the fourth quarter. The Kastelli bankruptcy had prevented the authorities from taking action in the third quarter, as they had had to provide emergency assistance to several banks up to amounts that were not easy to determine ex ante, making it difficult to indicate the amount of external liquidity creation that had to be absorbed by compensatory measures.

Third, discussions on the conditions for the present drawing had taken more time than envisaged, so that although it could normally have taken place at the end of October, it had been delayed and therefore fell under the conditions regulating the next tranche, Mr. de Groote stated. All drawings taking place after December 31, 1982 would be subject to the new understandings for the net domestic assets of the Central Bank in 1983, whether or not they pertained to a previous period. The formulation of the decision of August 23, 1982 might have been somewhat misleading on that point. It would not have been necessary to grant a waiver if that decision had mentioned that the reaching of new understandings on performance criteria for 1983 was linked only to the observance of criteria for end-December 1982. Paradoxically, Turkey had to request a waiver, despite reaching an understanding on the new credit policy for 1983 and observing performance criteria, because the earlier decision stated that all drawings after December 31, 1982 required an agreement by the Board on new credit policy targets, whether or not the drawing related to the December figures or to figures for a previous period for which no new credit targets had to be devised. Was a waiver required on that point, since heretofore specific criteria had been observed?

The text of the decision of August 23 stated that Turkey would not make any purchase under the stand-by arrangement "during any period after December 31, 1982 in which understandings have not been reached or are not being observed," Mr. de Groote continued. He understood that the text of that decision conformed to Fund practice and that it was acceptable to interpret the word "or" to mean "and." When a new period for the establishment of performance criteria began, a country was supposed to establish new policy targets and to demonstrate that it had observed the criteria. Turkey had observed that criterion but because of the length of negotiations it could not reach understandings for the new period, so that the word "or" was understood to mean "and." In conclusion, he stated that he was in favor of the proposed decision.

The staff representative from the European Department recalled that paragraph 4(a) of the decision of August 23, 1982 referred to conditions under which purchases could not be made: "During any period up to December 31, 1982, in which the limits on net domestic assets of the Central Bank of Turkey or its credit to the public sector specified in the table appended to the memorandum...are not observed." Paragraph 4(b) continued: "During any period after December 31, 1982 in which understandings have not been reached or are not being observed on (i) the net domestic assets...." He believed the decision referred to 1983 figures rather than to 1982 figures.

Mr. de Groote inquired whether the proposed decision could be changed to eliminate the waiver. In paragraph 2 it was stated that "no additional understandings are necessary regarding the nonobservance of the performance criteria." He suggested that the phrase be deleted as it was not pertinent.

The staff representative from the European Department agreed with Mr. de Groote that there were three elements in the proposed decision that referred to the original decision. First, there was the requirement regarding the absorption of reserve money, which had not been met. Second, there were the actual reserve requirement ratios, which were changed on January 1, 1983. Those two items continued in force in 1983, and it was therefore unnecessary to change them. The third element, credit limits, covered in paragraph 3, was much more complicated. It would have been possible to have the purchase under consideration without a change in the credit ceilings of the stand-by arrangement; however, the staff and the Turkish authorities had agreed that it was necessary to establish more appropriate credit ceilings. As the new credit limits were tighter than the old ones, the latter had been observed automatically. The December 31, 1982 credit position was the starting point for the 1983 program, and it seemed useful and desirable to incorporate it in a formal sense into the documents relating to the stand-by arrangement.

Mr. Laske remarked that two waivers were proposed in the document under consideration. One waiver concerned the nonobservance of the reserve requirement of banks as of December 31, 1982, which was due to the emergency assistance provided to the banking system by the Central Bank in the wake of the crisis in the financial community. The emergency assistance, in combination with unexpectedly strong developments in the balance of payments, had created excess liquidity in the banking system. In EBS/82/230, the staff reported that the authorities intended to mop up that excess liquidity through the sale of special bonds amounting to LT 10 billion and that the proceeds would be sterilized in the Central Bank. To what extent had the authorities been successful in selling such bonds? It might have been appropriate to reflect the Government's action in the wording of the decision rather than to waive the nonobservance of performance criteria. The second waiver concerned the understandings reached on credit ceilings for the remainder of the program period. Because such understandings had been reached by the mission to Ankara in December, they would be before the Board shortly, and he could agree to that waiver.

With regard to the establishment of adjusted credit ceilings for the last quarter of 1982, Mr. Laske said that he was somewhat puzzled that those ceilings should be approved by the Board after that quarter was over and after revised credit ceilings had been observed. Although he had no objection, especially as the proposed credit ceilings were lower than the previous ones, he wondered about the retroactive nature of the action and why it had not been possible to bring the matter to the Board before the end of the period to which the performance criteria applied.

A new system governing the reserve requirements of the banks had been announced, Mr. Laske recalled, which would have no significant effect on the amount of liquid reserves the banks were required to actually hold. Mr. de Groote had explained that the change involved, first, a tightening of the performance criteria by obliging the banks to hold those reserves on an average daily basis instead of only on one particular reporting day, and, second, a simplification by substituting a uniform reserve ratio for a diversity of ratios. He would like to be reassured that the action would not lead to the unintended release of cash reserves.

The balance of payments performance of Turkey had been better than expected, Mr. Laske commented, an outcome that should encourage the authorities to persevere with the adjustment policies that they had pursued under the stand-by arrangement. Although Turkey's economic performance had improved considerably over the past two years, the fight for a sustainable balance of payments position was not fully won. In the next few years, Turkey would have to redeem a sizable amount of foreign debt, which could be managed only if the current account continued to show strength and vigor. Any letup in the authorities' determination to push ahead with the adjustment of the economy would put the achievement of that objective in jeopardy, and would have negative repercussions on the willingness of the banking community to maintain lending to Turkey.

The formulation of the performance criteria for reserve requirements, introduced in the letter of the Turkish authorities dated July 20, 1982 and the attached policy memorandum, involved a quantification of the liquidity effect of applying those reserve requirements, Mr. Laske recalled. That quantification had not been disclosed to the Board either at the time of the program's consideration or at present. He suggested that in future cases of that nature, a schedule, similar to that for credit ceilings and other quantitative performance criteria, be annexed to the policy memorandum.

Mr. de Vries remarked that the contradictory factors described in the staff paper had made it difficult to reach a fundamental judgment. On the one hand, the Kastelli bankruptcy had made it necessary for the authorities to create additional liquidity. On the other hand, the attainment of a better net foreign exchange position, which did not require the creation of additional liquidity, had had that effect, although efforts had been made in the fourth quarter to correct that development. Although the paper (EBS/82/230) indicated that understandings had been reached for the period begun in 1983, it failed to describe the seriousness of the breach or the adequacy of the measures, so that making a judgment was difficult.

On another point, the retroactive establishment of performance criteria in the context of a stand-by arrangement was illogical, Mr. de Vries commented. On the basis of a stand-by arrangement, a country could have a credit line with the Fund if it pursued certain policies. The timing of the proposed decision ran counter to the very essence of a stand-by arrangement, and he hoped that the proposed decision could be changed in order to eliminate that difficulty.

He was encouraged by the favorable turnout of the balance of payments, Mr. de Vries said, although it was sometimes hard to discern from the paper what had brought it about. Undoubtedly, the vigorous adjustment policies of the authorities had contributed to the improvement, but the international situation was difficult, and many countries, falsely encouraged by success, had let up on the adjustment effort. He urged the authorities to complete their adjustment process with vigor, and he looked forward to further discussion when the new program would come before the Board.

Finally, Mr. de Vries commented, the staff had previously adopted a helpful procedure of stating in the cover note the amount of credit involved in proposed changes in stand-by arrangements or in the reviews; it had not done so in the present case. It would be useful if the figures could be included for all such papers in future.

Miss Le Lorier commented that perhaps part of the discussion was due to the solemnity attached to the granting of a waiver. She had no objection to the waiver procedure as a means of obtaining an explicit point of reference for the 1983 program. The inconvenience was that the procedure seemed to indicate that the country had failed to observe the performance criteria, which, in fact, was not true. Perhaps the waiver could be redrafted to make it clear that Turkey had complied with the criteria on credit ceilings.

Turning to the economic aspects, Miss Le Lorier welcomed the *reorganization of the system governing the liquidity and cash reserve* requirements of commercial banks as outlined in Supplement 1. She fully supported the proposed decision, with the qualification she had mentioned. She welcomed the slight tightening of net domestic assets and credit to the public sector extended by the Central Bank as a response to the overshooting of monetary targets. While she agreed with the staff that recent developments should not prevent a further deceleration of inflation in 1983, and that the other objectives of the program should also remain unaffected, she wished to add that those developments clearly underlined the uncertainty still associated with the smooth outcome of the past year's program. Would the staff state whether it considered the new arrangement currently in place sufficient to enable the authorities to cope with any possible recurrence of the phenomena observed in the second half of 1982, or whether it believed that the question should receive further attention during the second half of the third year of the program?

She would appreciate clarification of one aspect in particular, Miss Le Lorier said. The report indicated that banks with deposits that had increased unusually fast would be called upon "to purchase special bonds in an amount totaling at least LT 10 billion" and that "these banks will not be able to apply holdings of such bonds to meeting their statutory liquidity requirements." While she had no difficulty with the measure itself, she was not clear about the options open to the Central Bank, assuming a marked lack of enthusiasm on the part of the banks concerned for buying such bonds, especially if those banks were the same *that had failed to meet their legal liquidity requirements or their* reserve requirements. She would welcome some elaboration on the adequacy of the policy instruments at the disposal of the authorities.

Mr. Taylor stated that he supported the proposed decision in Supplement 1 to EBS/82/230, including the waiver of performance criteria relating to understandings regarding the credit ceilings for 1983, as such a waiver seemed to be formally necessary, according to the staff. He agreed with Mr. de Vries that it seemed anomalous to be setting performance criteria on the net domestic assets of the Central Bank retrospectively, and he would appreciate further comment by the staff.

It was unfortunate that several of the financial targets had been missed in the autumn as a result of domestic banking difficulties and unexpected balance of payments developments, Mr. Taylor said. In the circumstances, the authorities had had little room for maneuver, which illustrated the problem they had had in responding quickly and flexibly to changing conditions and also reflected the relatively undeveloped structure of the Turkish financial sector. He therefore urged the authorities to proceed as quickly as possible with the enactment of the proposed banking law; it was hoped that high priority would be given to stricter regulation and more thorough supervision of the banking system, together with the development of more readily usable policy instruments. The other proposed measures to restrain the rate of monetary expansion were to be welcomed; their implementation represented a strong effort to adhere to the general policy aims under the program. The decision to simplify the banks' reserve requirements and to modify the application of the prescribed liquidity requirements appeared to be a sensible step. The Central Bank had been able to hold its domestic assets down to the proposed new limit in the December period, but, like Mr. Laske, he wondered what progress had taken place toward mopping up the excess liquidity through special bond purchases.

It was not clear from the staff papers, Mr. Taylor remarked, how the latest efforts would affect progress in the evolution of money supply and thus the impact on expenditures and inflation in the economy, which were matters of substantial concern. When the program for the third year of the arrangement had been discussed in August 1982, there had been indications that the money supply had grown much faster than planned; apparently the overshooting had continued into the autumn. The papers under consideration indicated that higher real interest rates seemed to have strengthened the demand for money in the economy, which suggested that there was something wrong with the structure of interest rates and that there were deficiencies in monetary control.

Although the staff believed that the new measures would enable the economy to revert to a more even keel, that inflation would not reaccelerate, and that the objectives of the program would not be materially affected, it was natural to be somewhat uneasy in view of what had happened in the past, Mr. Taylor commented. He looked forward to a fuller discussion of the issues during the following month's review of progress during the third year of the program.

Finally, he noted, like others, that it had taken a rather long time, following the detection of the breaches of performance criteria, to bring the request to the Executive Board, Mr. Taylor stated. As a result, there had been the procedural and legal complications mentioned by others. Although there might have been practical reasons for the delay, he urged the staff to bring its proposals for dealing with such situations to the Board as soon as possible after the event.

Mr. Kabbaj stated that he supported the proposed decision revising the credit limits and targets set during the previous Board discussion on Turkey. The letter from the Turkish Minister of Finance adequately explained the latest developments in the credit market, and he agreed with the course chosen by the authorities in the face of a sudden turn of events. During the forthcoming discussions for the midyear review of the program for the third year of the stand-by arrangement, which he understood would be scheduled shortly, the opportunity undoubtedly would be available to monitor more closely the longer-term economic trends in Turkey. At the present stage of the program, it was apparent that a major adverse development in the banking and credit sectors had resulted in a higher growth of central bank credit than was either expected or desirable; but it had nevertheless been necessary in the circumstances to avert a crisis of confidence and to restore public trust in credit institutions. Despite such adverse developments, inflation had abated and other credit limits and performance criteria had been scrupulously observed, showing the determination of the authorities to pursue the adjustment program to its successful end.

He requested further clarification and elaboration on two points, Mr. Kabbaj said: the unexpected strengthening of the balance of payments, and the relative lack of usable credit policy instruments to sterilize external liquidity injections. Finally, he wished to commend the authorities for having managed to cope so well with developments during a most uncertain period for the world economy.

Mr. Dallara stated that his authorities supported the proposed waiver and modification because the objectives of the program would not be materially affected by the decision and because the Turkish authorities planned to initiate or continue offsetting measures. Like Mr. de Vries and others, however, he would appreciate further comment on the establishment of performance criteria in a retroactive sense.

He wished to stress the importance of greater control of monetary growth by the authorities, Mr. Dallara continued. The fact that the higher than expected monetary growth had not yet been reflected in domestic prices was not particularly reassuring, in light of the delays that had occurred in adjusting some administered prices and of the lag in the response of prices to money growth. Like other Directors, he urged the authorities to implement firmly their policy adjustments that were aimed at regaining better control of the monetary aggregates.

He welcomed the authorities' steps to reorganize the system governing the liquidity and cash requirements of commercial banks, Mr. Dallara stated, and hoped that those changes would contribute to a more stable reserve money multiplier. He wondered whether sufficient policy adjustments were now in place to take care of the problem of excessive monetary growth, and he would appreciate further comment from the staff or Mr. de Groote. Like Mr. Taylor and others, he looked forward to the following month's Executive Board meeting on Turkey to consider the ceilings applicable to the remaining portion of the program. He hoped that at that time the staff could reassure the Board that problems of excessive monetary growth were in fact being dealt with effectively.

Mr. Feito stated his support for the draft decision presented in Supplement 1. He also endorsed Mr. de Groote's remarks on the need for simplifying procedures, when possible, without neglecting the legal requirements. It was clear from the staff papers that the injections of liquidity through the unexpected sharp strengthening of the balance of payments had led to an expansion of the monetary base well beyond the planned amount. At the same time, the loss of confidence in the banking system had prevented the Turkish authorities from offsetting the liquidity expansion. He wondered whether the better than expected balance of payments outcome was temporary and whether it had been the result of more favorable developments in the current account or of greater capital inflows. He looked forward to a more detailed discussion at the next meeting on Turkey.

He commended the Turkish authorities on their prompt and appropriate response to their financial problems, Mr. Feito commented. He shared the staff's view that the uniform reserve requirement system would contribute to a more stable link between the monetary base and money. He believed that the measure represented an adequate response that would preserve the stabilization efforts entailed in the program.

Mr. Lovato supported the proposed decision concerning the modified performance criteria for the observance of reserve requirements under the stand-by arrangement for Turkey. The staff's arguments assessing the Turkish decision were sufficiently strong to endorse such a change.

He also supported the proposed waiver, Mr. Lovato continued, although with some reservations, stemming from the fact that it had been requested ex post facto. He did not question in any way the legitimacy of the request prompted by unforeseen and exceptional events, but he was worried that similar cases might occur. More precise guidelines would then become necessary.

Mr. Malhotra said that he supported the request for the waiver and modification of performance criteria, for the reasons cited by the staff.

Mr. Morrell stated that he could agree to the proposed waiver, because it reflected developments partly beyond the authorities' control and because the broad program remained basically on track, particularly as the credit ceilings had not been breached. He could also agree to the proposed modification of performance criteria for the fourth quarter of 1982, although he shared the concerns of many other Directors about the retrospective nature of the modification. However, a distinction should be drawn between negotiations with the staff taking place for an existing program before the end of the period and those that did not arise until after the period. The request had come to the Board before the end of December, and he believed that, as the staff had the authority to discuss those matters, it should not be totally denied the ability to discuss modifications before the end of the period.

The proposed changes in the banking requirements were of some concern, Mr. Morrell commented. In view of the crisis of confidence that had taken place in the Turkish banking community, he was not clear whether the new requirements actually resulted in an overall reduction in the liquidity requirements of the banks. He would look unfavorably at any move that resulted in a weakened liquidity requirement for the banking system. There had been a number of comments about the measures taken by the Turkish authorities regarding monetary policy, and he wondered whether the staff was satisfied with the course of monetary developments in Turkey at the moment.

Mr. Suraisry stated that he supported the request for a waiver and modification of performance criteria, and agreed with the staff and other Directors that the objectives of the program would not be affected. Mainly owing to developments in the nonbank financial institution sector, it had become difficult to meet the performance test on the absorption of bank liquidity. The Central Bank had taken certain measures to remove deficiencies in reserve requirements, but they were insufficient, and the authorities had had to help those financial institutions affected by the bankruptcy to minimize its effects on the monetary sector and to restore confidence in the banking system.

The authorities should take whatever steps were needed, particularly in the monetary control field, to enable the economy to meet all the performance criteria, Mr. Suraisry remarked. He welcomed the steps that the authorities had taken, and were about to take, to ensure the achievement of that important goal.

Mr. Abiad stated his support for the proposed revised draft decision.

Mr. Joyce said that he also supported the proposed decision and the request for waivers, but shared the concerns expressed by others about the broader implications of granting waivers and entering into ex post arrangements. He, like Mr. de Vries, looked forward to a closer consideration of developments and progress with regard to the adjustment process during the Board discussion in February. He would appreciate further information concerning the degree of success of the sale of special bonds amounting to LT 10 billion to commercial banks by mid-December 1982.

Mr. Habib said that he supported the request for a waiver and modification of performance criteria, as well as the proposed draft decision.

The staff representative from the European Department explained that the failure of Turkey to observe the performance criterion had first become known to the staff in October 1982. Discussions had been instituted immediately to find out what had happened, and to agree with the authorities on the appropriate actions. Meanwhile, the Turkish Government had scheduled a referendum for a substantial change in the Constitution, and felt unable to take major policy actions until its approval. Therefore, it was not until the end of November that discussions with the authorities could be concluded, and December before a paper could be prepared and issued to the Board. In different circumstances, the matter would have been before the Board in early November and decided well in advance of December 31. Many of the problems concerning timing mentioned by the Executive Directors resulted from the delay due to the referendum and to the full four-week period for consideration of the paper necessary before the Board took a decision.

A review paper would be issued shortly discussing developments in 1982 in detail and the program for 1983, the staff representative added. Its issuance was evidence that the staff believed that the present situation and the policies proposed for 1983 were a satisfactory continuation of the adjustment process. The sale of special bonds, in an amount of LT 10 billion, to those banks that were in easy liquidity situations had, in fact, taken place. The end-year results for central bank credit to the public sector indicated that the revised ceilings had been observed. It was worth noting that the Turkish authorities, in order to have a program considered satisfactory by the staff, had to act as if the revised ceilings were in operation. If they had not taken action, they could still have remained within the existing credit targets under the stand-by arrangement and thus have met the performance criteria, but they would not, either in the staff's view or in their own view, have been following a satisfactory credit policy. The staff therefore continued to believe that there would be an advantage in changing the formal performance criteria on credit ceilings, even retroactively. The authorities were, in fact, operating according to the proposed revised decision.

An important factor was that the balance of payments, on both current and capital accounts, had been better than the Turkish authorities and the staff had expected, the staff representative commented. In different circumstances, it might have been possible for the Central Bank, through the tightening of reserve requirements, to absorb the excess liquidity coming into the economy through the balance of payments. However, the liquidity situations of the banks were by no means uniform: some were in great difficulty because of the Kastelli bakruptcy; others were quite liquid. The only policy measure open to the authorities when the difficulty had arisen had been a general across-the-board tightening of liquidity, which would have been counterproductive in view of the Kastelli affair. After discussions with the staff, the authorities had decided that the best way to counteract the excess bank liquidity was by selling bonds to those banks that were in an excessively liquid position, without raising general liquidity holding ratios. The overall result had been a satisfactory one, with the sales of bonds, in effect, absorbing the liquidity that had not been absorbed as originally intended.

Regarding the liquidity arrangements, the new uniform ratio would maintain the banks' liquidity position, the staff representative remarked. Compared with the previous highly selective sets of liquidity holding ratios, the reserve requirement obligation was simplified, without a change in the effective level of the obligation. The new system for cash liquidity requirements of the banks would operate on a daily basis, compared with the previous system, which had operated one day a month and was therefore open to circumvention by window-dressing operations. The new arrangements were more satisfactory from an operational point of view, without weakening the liquidity requirements of the banks.

The balance of payments position had improved substantially, particularly on current account, the staff representative from the European Department concluded. Latest estimates indicated a deficit of LT 1.1 billion, compared with the program target of a deficit of LT 1.4 billion in 1982. The authorities planned a further reduction in the rate of inflation in 1983. The forthcoming paper for Board consideration recommending the program for the remaining period of the stand-by arrangement was evidence that the staff believed the 1983 program to be a reasonable one.

The Deputy Director of the Exchange and Trade Relations Department confirmed that when discussions had taken place with the Turkish authorities in November, it had been the intention of the staff, as well as of the Turkish authorities, that the revised credit figures would be treated as performance criteria for the purchase that would be available after mid-February.

The staff representative from the Legal Department commented that the decision had been criticized as unduly complicated. The staff would prefer simplified procedures and decisions, but the situations and variables encountered were complex, thus occasioning some of the issues exposed at the present meeting. The decision had two distinctive features. The first was the timing; had the decision reached the Board before December 31, it would have been phrased somewhat differently, and the situation would have been quite different; had it been delayed until the general review, there would have been a normal review decision. The second feature was that, as the result of the first, a waiver was needed because of the failure to reach new understandings, according to the third-year decision of six months ago, by December 31, 1982. In certain waiver decisions, the Board did not require any new understandings for the purchases to continue. But that would have been paradoxical in the present case, because new understandings could be expected for Board consideration in one month.

Each paragraph of the decision responded to a particular problem, and it was the underlying complexity, rather than the paragraphs themselves, that was the cause of the problem in understanding, the staff representative observed. However, the precise drafting need not be defended and was possibly open to improvement. In response to Mr. de Groote, regarding the need to reach new understandings to permit a purchase at the present time and particularly the formula of paragraph 4(b) of the decision of August 23, 1982, it did not seem as simple as replacing "or" with "and," although that was an interesting concept. That wording was designed to reflect the intent that for 1983, in the normal circumstances, a review decision establishing the general quantitative performance criteria would have to come before the Board. The review decision would not have to address those performance criteria for the third year that were ongoing.

Perhaps something was missing in the drafting, but the intent was to indicate that new understandings had to be reached or, if they had been reached, that they had to be observed.

In response to Mr. de Vries' question regarding the need for paragraph 3 of the proposed decision, the staff representative explained that the paragraph had been designed as a modification rather than a waiver. There had been some discussion whether to insert the paragraph in the decision; legally, it had very little effect at the present time. It was not a limit on purchases because, according to his interpretation, new performance criteria were needed after December 31. They had not been reached pending further Board review, and that requirement was being waived. However, there was a linkage between the ceilings and those that would be put to the Board shortly. On previous occasions, the difference between effective performance criteria as ceilings and indicative ceilings had been discussed. Although the present ceiling was subject to continuous testing and was not, therefore, indicative in the simplest sense, the staff and the Turkish authorities saw a continuation in the adjustment effort relating to those ceilings. Legally, the paragraph was within the power of the Board, but were the paragraph to disappear, it would make no difference to the operational effect of the other parts of the decision.

It had been suggested by Miss Le Lorier that paragraph 3 should state that a waiver was not required because the performance had been satisfactory no matter which standard was taken, the staff representative from the Legal Department recalled. However, in light of the reference to complicated drafting, as paragraph 2 cited explicitly the two specific waivers required for further purchases, the third paragraph should not include similar terminology. Paragraph 3 referred not to a waiver but to a substitution of other figures; other evidence would be required to know whether those ceilings had in fact been respected.

Miss Le Lorier suggested that the phrase in paragraph 3 of the decision be redrafted to read "in place of those higher limits referred to in paragraph 4(a)," to indicate that in fact the Turkish authorities had observed lower credit ceilings than the targets.

The staff representatives from the European and Legal Departments concurred.

Mr. de Vries remarked that a fundamental matter was involved: the protection of member countries by appropriate procedures. Although he could understand how the staff had been caught by the time constraint, he was disappointed to hear it continue to argue in favor of retroactive proposals. Because it would set a bad precedent, he would have to oppose the decision if the paragraph remained unchanged. Apparently paragraph 3 was not required to grant the waiver; the decision could include elsewhere a reference to the fact that certain credit policies had been observed during the previous period and that a waiver was granted.

Mr. de Groote agreed with Mr. de Vries. The present stage of negotiation would be reflected more accurately if the decision stated that the Fund noted the intention of the Turkish authorities to implement revised ceilings. Thus, it would not appear as an element of the decision but as information to be taken into account. He wished to reaffirm that the text modification did not reflect misunderstandings between Turkey and the Fund; the Turkish authorities' intentions were clear. His suggestions were merely to provide a decision without ambiguity.

Paragraph 2 of the proposed decision presented major problems, Mr. de Groote continued. The Turkish authorities had in fact reached an understanding on their credit policy targets for 1983. Such an agreement was necessary, according to the spirit of the previous decision, because drawings were to be made in 1983 on the basis of December 1982 figures, not because the drawing that was to have been made in October 1982 would be on the basis of July figures. The paragraph introduced a notion that somehow the Turkish authorities had not observed a criterion that they could not have observed in any case. He proposed that the paragraph read: "The Fund finds, in view of the circumstances...that no additional understandings are necessary regarding," perhaps deleting "the nonobservance of the performance criteria relating to," and continuing "the absorption of liquidity." Then it could read: "The Fund finds, in view of the same circumstances, that no additional understandings are necessary regarding the reaching of understandings with the Fund in accordance with paragraph 4(b) of Executive Board Decision No. 7189-(82/115), adopted August 23, 1982." He recommended that the suggested amendments to paragraphs 2 and 3 be accepted.

The staff representative from the Legal Department remarked that the suggestions would be included in a revised decision.

Mr. de Groote suggested one minor change relating more to clarification than to substance. In paragraph 2, line 8, after "no additional understandings are necessary," the phrase "regarding...in accordance with" should be changed to "pursuant to."

His Turkish authorities were fully aware of the need to adjust, Mr. de Groote remarked; they would be in a position to give more information on their medium-term policy intentions when Turkey would be discussed by the Executive Board shortly. Undoubtedly, Turkey's program was successful, and those successes justified a continuation of the very serious efforts that had been undertaken. A most important topic to be discussed would be how, beyond the three-year program period, Turkey could continue to cooperate with the Fund in order to achieve fully both the fundamental structural adjustment under way and a viable balance of payments position.

The Executive Board then took the following decision:

1. Turkey has consulted with the Fund in accordance with paragraph 3 of the stand-by arrangement for Turkey (EBS/80/126, Sup. 3, 6/19/80).

2. The Fund finds, in view of the circumstances described in EBS/82/230 and Supplement 1, that no additional understandings are necessary regarding the absorption of liquidity through the stricter enforcement of and increase in the reserve requirements of banks referred to in paragraph 4(c)(ii) of Executive Board Decision No. 7189-(82/115), August 23, 1982. The Fund also finds, in view of the same circumstances, that, for purchases before February 18, 1983, no additional understandings are necessary pursuant to paragraph 4(b) of Executive Board Decision No. 7189-(82/115), adopted August 23, 1982. Accordingly, Turkey may proceed to request purchases under the stand-by arrangement, provided that cumulative purchases under the arrangement shall not exceed the equivalent of SDR 1,060 million until further review by the Fund.

3. The Executive Board notes the decision of the Turkish Government, described in paragraph 3 of the communication from the Minister of Finance dated November 29, 1982, to lower the limits on net domestic assets of the Central Bank and on central bank credit to the public sector for the final calendar quarter of 1982 to levels below those referred to in paragraph 4(a) of Executive Board Decision No. 7189-(82/115), August 23, 1982.

4. In accordance with the communication from the Minister of Finance dated December 31, 1982, the reserve requirements of banks referred to in paragraph 4(c)(ii) of Executive Board Decision No. 7189-(82/115), August 23, 1982 and specified in the penultimate sentence of paragraph 3 of the memorandum attached to the letter dated July 20, 1982 shall be, for the period beginning January 1, 1983, those referred to in the final sentence of the communication dated December 31, 1982.

Decision No. 7302-(83/10), adopted
January 12, 1983

3. DENMARK - 1982 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1982 Article IV consultation with Denmark (SM/82/229, 12/9/82). They also had before them a report on recent economic developments in Denmark (SM/82/238, 12/28/82).

Mr. Sigurdsson made the following statement:

The Danish authorities want to express their appreciation of the staff report, which gives a well-balanced evaluation of the Danish economic situation on the basis of last October's consultations.

Despite an unfavorable international environment from a Danish point of view the deficit on the current account was reduced moderately in kroner terms during the period 1979 to

1981. Due to restrictive economic policies, domestic demand fell, and since Danish industry's competitive position improved, the trade balance developed in a positive way, in 1981 Denmark had a surplus on its goods and services account for the first time since 1972. However, to a considerable extent, the effects of the improved trade balance were counteracted by a rapid increase in net interest payments on the external debt. Part of the deterioration on the interest balance can be explained by the increase in the debt, but simultaneously the net interest account was negatively influenced both by the increase in international interest rates and by exchange rate developments.

While balance of payments developments in 1980 and 1981, considering the unfavorable international environment, were moderately satisfactory, the Danish authorities agree with the staff that developments in 1982 were much less satisfactory. In 1980 and 1981, domestic demand in Denmark was more sluggish than in most other European countries, but in 1982 domestic demand increased by about 2.5 per cent, while real domestic demand in Western Europe on average hardly seems to have increased. Part of this deviation can be attributed to very considerable investments in the Danish oil and gas sector in 1982; but inter alia on account of a weakening of fiscal policy, both private and public consumption also increased in 1982. As net interest payments on the external debt were showing another sharp increase, it is likely that the deficit on current account will increase from DKr 12.6 billion in 1981 to about DKr 20 billion in 1982 (SDR 2.3 billion on the basis of the rate existing at the end of 1982). Even under these assumptions it is estimated that 1982 will show a modest surplus on the balance of goods and services.

The new Government, which took office in September, was very concerned about the economic situation. It considered a reversal of the existing trends to be of paramount importance both in the short run and--even more--in a longer-term perspective.

As pointed out in the staff report, the Government has spent much of its four months in office working on the adoption of its proposals to dampen substantially the upward trend in money wages and social transfers. Simultaneously the Government is endeavoring to brake and subsequently reverse the sharp upward trend in the budget deficit.

Incomes policy

As a result of the desire to dampen very substantially the rate of wage increases, a wage freeze was introduced covering the winter half year; simultaneously the automatic index adjustment of wages and salaries was suspended until the spring of 1985. At the same time the Government indicated that a 4 per cent a year increase will be the maximum rate that the Government, as an employer, will accept as an average salary increase in the public sector in a two-year period starting April 1, 1983. The 4 per cent increase should also be seen as a norm for the private labor markets. Apart from the ban on automatic index adjustment, the employers and the trade unions have kept their right to enter into wage agreements agreed by both sides. With a view to strongly underlining the need for a very moderate wage development, Parliament banned wage-wage links in October 1982 for half a year with the effect that reintroduction of such systems will not take place unless agreed at the negotiating table. Furthermore, a majority in Parliament has indicated willingness to consider a small easing of income taxes for 1983 if the wage settlements keep to the norm. The wage negotiations in both the private and the public sectors have now started, but at this stage I am not able to give any estimates regarding the final outcome.

Fiscal policy

The new Government was also very concerned about the rapid deterioration in the budgetary situation of the Central Government, which took place in the course of 1981 and 1982. Looking to the 1983 budget, the Government has had a clear preference for achieving an improvement of the budgetary situation by means of expenditure cuts rather than by way of tax increases. Although the emphasis in the endeavors to strengthen the budget accordingly has been on the expenditure side, the 1983 budget adopted in December contained elements both of expenditure cuts and of increases on the revenue side.

To a large extent, the proposals tabled by the Government in the beginning of October aimed at containing the growth in individual unemployment benefits and other politically sensitive areas of social welfare and housing expenditures. In some instances it proved impossible to create a parliamentary majority for the original proposals, which therefore had to be amended or replaced by other proposals. Overall, the intended improvement of the budget has been reached to a high degree. With respect to public consumption and investment, expenditure policy has to a large extent been directed toward local authorities, who in Denmark are responsible for more than 50 per cent of these expenditures. By reducing the grants paid out from the Government to the local authorities, the Government has indirectly applied pressure on the local authorities to achieve a higher degree of economizing on public resources. Without these efforts, it was anticipated that the deficit of the central government current, investment, and lending budget in 1983 would have amounted to DKr 80 billion.

After the adoption of the expenditure cuts and some revenue proposals (including a new tax on the accumulated funds in insurance and pension funds), it is estimated that the 1983 deficit will amount to DKr 69 billion. In the view of the Government, the proposals regarding 1983 should be seen as only a beginning to the much-needed process of improving the budgetary situation, and it is the firm intention of the Government to reduce the budget deficit further in 1984.

On the basis both of the fiscal measures that have been adopted and of the expected moderation in Danish wage costs, it is now expected that private consumption and domestic demand in general will be practically unchanged in volume terms in 1983 compared with 1982. At the same time, however, the tightening of incomes policy is expected to strengthen the competitive position of Danish firms. Because of an expected improvement in the balance of goods and services, it is, therefore, expected that GDP in volume terms will increase by 1 per cent in 1983. With such a moderate increase, however, a modest further increase in unemployment in 1983 will be unavoidable.

This 1983 outlook and the prospects for the following years easily explain why in December the Government announced its intention of seeking ways to stimulate investment activity. The emphasis will be on private investment, including the building industry where activity has fallen to a low level. The budgetary impact of these measures is rather limited, since the proposals are concentrated on efforts to improve the general business climate in Denmark. However, it is acknowledged that the possibilities for achieving an upswing in private investment are limited as long as both external and internal demand are likely to remain sluggish.

Monetary policy

As pointed out in the staff report, Danish monetary policy was faced with a dilemma in 1981 and 1982. On the one hand, the desire to counteract a sharp decline in domestic investment activity worked in favor of an easing of monetary policy; external factors, on the other hand, have meant that there was practically no leeway for any such easing. In the course of the second half of 1982, this dilemma became somewhat less pressing as international interest rates declined. Still, against the background of the large financing needs of the Government, and considering the constantly changing situation in foreign exchange markets, the possibilities for an easing of Danish monetary policy are very limited.

External sector policies

With respect to exchange rates, the new Government, immediately after taking office, had to take a position as the Danish krone was under considerable pressure early in September and again--on a more moderate scale--in October. On this occasion the Government declared that the exchange rate for the Danish krone would be maintained, and that statement has been repeated several times since then. In the Government's opinion, it is of crucial importance to Denmark that the cooperation within the European Monetary System (EMS) should continue to function in a satisfactory way. There is clearly room for improvement in the field of convergence within the EMS, and it is to be hoped that the measures adopted in Denmark in the course of last autumn can be one element--albeit small--in a better convergence. After three adjustments of central rates within the EMS in a period of less than nine months (in 1981-82), the Danish Government is of the opinion that it would be desirable, and to the advantage of the EMS as such, if exchange rate adjustments within the System were to become less frequent.

Before concluding my remarks on economic policy, I would like to emphasize that the Danish Government will continue--both within the GATT and within the EC--its policy of opposing protectionism in its direct as well as more indirect forms. I may also add that the Danish Government, despite the budgetary difficulties with which it is faced, has decided to maintain aid appropriations to developing countries at their present relatively high level of 0.73 per cent of GNP in 1983.

The future development of the current account of the balance of payments will depend heavily on developments in the exchange rate for the dollar, international interest rates, and energy prices. On the basis of cautious assumptions with respect to these factors, and of the expected improvement in the competitive position, my Danish authorities are expecting an improvement of the current account position by about DKr 3 billion (about SDR 0.4 billion) in 1983. Although there should be a moderation in the increase in the deficit on the interest account, the anticipated improvement of the current account is expected to reflect an increase in the surplus on the goods and services account by about DKr 6 billion. The total current account deficit in 1983 is expected to amount to DKr 17 billion (about SDR 2 billion), which will correspond to about 3.5 per cent of the expected nominal GDP in 1983.

In the somewhat longer term, the Danish balance of payments situation should be influenced positively by an expected increase in energy supplies from the Danish part of the North Sea, and by a reduction after 1983 in the capital expenditures in the oil and gas sector. Still, the Danish Government is vividly aware of the fact that the decisive factor in securing a substantial and enduring reduction of the deficit on the current account for the years following 1983 will be the success in achieving--also in a longer-term perspective--the twin objectives of maintaining a much lower increase in wage costs than in the recent past, and a continued improvement of the budgetary position of the public sector.

Mr. Lovato commented that Denmark represented an interesting case of the conflicts between general economic policies and their social aspects, as well as the consequences of giving more emphasis to some policies than to others. Faced with an external deficit, the Danish authorities had decided to take the measures needed to strengthen competitiveness. They had succeeded in reducing unit labor costs, increasing the export market share of the country, and lowering the current account deficit, thanks to both a large improvement in industrial labor productivity and a devaluation. Denmark had a greater labor market mobility than other countries, and the system took advantage of it; but by doing so the productive units caused unemployment to rise to a level that induced the authorities to shift the emphasis of their economic strategy, in particular their fiscal policy, from external adjustment to employment support in 1981 and the first part of 1982. The situation worsened in both the public sector and the current account deficit to the point that in September 1982 the authorities had had to intervene with a restrictive economic program.

Taking into consideration the stagnation in real GDP and a further increase in unemployment, as well as the difficulty of expanding exports because of the international recession, he could understand the Danish authorities' efforts to develop and carry on an employment support scheme, Mr. Lovato observed. There were, however, two considerations: first, in his view too many abrupt changes of policies in a relatively short period were always a cause of uncertainty and normally had destabilizing effects; second, the mobility of resources in a system was a positive feature, but he wondered--in light of the Austrian experience--whether consideration of the labor force could not induce the unions to a more moderate wage policy.

The marked increase of the current account deficit in 1982, the decline of gross official reserves, and the level of Denmark's debt service ratio were matters of concern, Mr. Lovato said. The authorities did not seem to have the economic tools at hand to reverse the situation in the short run. Despite further improved competitiveness of the system, they could not increase their market share because of the sluggish export market; net interest payments abroad could not decline for the time being; and the construction of a natural gas network and an oil pipeline was necessary to avoid a further increase in unemployment and to continue the energy-saving program.

The private consumption upturn of the past year would have to be reversed through action by the authorities in two fields: the public sector deficit and wages policy, Mr. Lovato stated. The measures proposed by the Government to stop and eventually reverse the upward trend in the public sector deficit were welcome. He agreed that at present it was better to rely on measures on the expenditure side, particularly by cutting social and income transfers, while refraining from reducing significantly the employment support scheme until an upturn of economic activity occurred. Such a balanced budget policy, although not the optimum for reaching equilibrium rapidly, could help obtain the support of the unions on incomes policy.

He commended the intention of the authorities to rely on wage restraint, Mr. Lovato continued. He endorsed the proposal to suspend wage indexation, which had been the main cause of wage increases during the past two years; he would prefer its complete elimination and the substitution of a flexible bargaining policy, but that might require better understanding between the partners. Given the present situation, even with the suspension of wage indexation the reduction of purchasing power could endanger the credibility and therefore the feasibility of the program. The staff doubted that the rate of wage increase could be brought down to the target of 4 per cent a year until 1985. A failure of the incomes policy would compel the Government to adopt alternative measures. He appreciated the determination of the authorities not to resort to a unilateral devaluation under the EMS arrangement, as it would make the reduction of inflation much more difficult and would remove the entrepreneurs' incentive to improve competitiveness by increasing productivity.

A reduction in the government deficit and a suitable incomes policy would be key elements for a slower increase in prices and for a further reduction in interest rates, Mr. Lovato remarked. However, he doubted that "a reduction in the government deficit and real interest rates would stimulate business fixed investment and private sector employment, and obviate the need for applying costly budgetary investment incentives," as stated in the staff appraisal. He also doubted that it could work simply and quickly, given the high level of idle capacity. He shared Mr. Sigurdsson's view that "the possibilities of achieving an upswing in private investment are limited as long as both external and internal demand are likely to remain sluggish." He did believe that a reduced government deficit and an appropriate incomes policy would help to make the implementation of monetary policy, which was conditioned by external considerations, less difficult and would create a better climate for sustainable economic growth.

Mr. Grosche said that before speaking on the Danish economy, he would like to comment on procedures. Denmark was another country with which Article IV consultations had been delayed significantly. Again, he wished to express his authorities' view that Article IV consultations should not be delayed excessively, in particular with industrial countries and with those developing countries facing serious economic problems.

Since March 1981, when the previous Article IV discussion had been completed, the economic situation in Denmark had deteriorated further, Mr. Grosche commented. The Danish authorities were facing large imbalances in the economy. Unsustainable current account and public sector deficits coincided with increasing unemployment and high inflation. External factors, such as the international recession, high international interest rates, and the substantial strengthening of the U.S. dollar, had adversely affected the small and open economy of Denmark. However, it was hard to escape the conclusion that a wrong mix of fiscal, monetary, and wage policies had compounded the problems instead of adjusting the economy to the changing external environment.

The public sector financial deficit, which had been modest in 1979--1.5 per cent of GDP--had risen sharply and was estimated to have reached 9 per cent of GDP in 1982, Mr. Grosche remarked. Another cause of concern had been the renewed acceleration of wage costs. Those developments had imposed a drain on the balance of payments and had caused inflationary pressures that had forced the authorities to pursue a tight monetary policy. The restrictive stance of monetary policy had been unavoidable under the circumstances, but high interest rates had depressed business investment and had compounded employment problems.

With regard to the economic stabilization program adopted by the new Government, he supported the thrust of the program, which was designed to strengthen competitiveness and to halt and eventually reverse the trend toward higher budget deficits, Mr. Grosche said. The program was an important first step in the right direction, and he was pleased to note from Mr. Sigurdsson's statement that the new Government considered a reversal of the existing trends to be of paramount importance. The Government's emphasis on wage restraint, in particular through the suspension until the spring of 1985 of the automatic index adjustment of wages and salaries, was welcome. Also, the Government's intention to limit annual salary increases in the public sector to 4 per cent in the two-year period ending early 1985 might help to bring about wage agreements in the private labor market that would take account of Denmark's difficult external position. The authorities should be commended for having taken those steps, which were politically difficult. It was to be hoped that the unions would take those limits as a guideline in their wage agreements; the outcome of the imminent negotiations was crucial for the success of the program. On page 9 of SM/82/229, the staff noted that "the extent to which private sector wage rates can be brought down to the target rate of 4 per cent per annum during the forthcoming agreement period remains uncertain, given the likely occurrence of wage drift," whereas on page 3, the staff noted that the wage drift had dropped considerably, from 6.7 per cent in 1980 to 2.5 per cent in 1982. He wondered whether the two remarks were contradictory.

It would be unnecessary to resort to a devaluation to improve external competitiveness if the objective of limiting wage increases in the public and private sectors were achieved, Mr. Grosche commented. In that regard, his authorities highly commended the Danish Government for having ruled out a devaluation of the krone as a means of improving competitiveness after the substantial devaluation of the Swedish krona in October 1982. That decision contributed significantly to the avoidance of a run into competitive devaluations, in particular inside the European Monetary System. He appreciated Mr. Sigurdsson's statement that the Danish Government believed that it would be to the advantage of the European Monetary System if exchange rate adjustments within the System were to become less frequent.

The authorities had implemented important measures aimed at stabilizing the deteriorating budgetary situation, Mr. Grosche concluded, rightly concentrating on expenditure restraint; only such revenue measures as would not add to existing disincentives had been proposed. He was concerned that the central government deficit was expected to rise to an estimated 13 per cent of GDP in 1983 and further thereafter. The authorities should not rely too heavily on an uncertain early recovery to help to cope with that problem. The Government's intention to adopt further expenditure cuts after 1983 was therefore very welcome.

Mr. Casey remarked that after some years of good demand management policies, fiscal policy in Denmark had become more expansionary in 1981 and 1982 because of the authorities' concern about the unemployment rate, which was high. That expansionary stance appeared to have been misguided for several reasons. First, a large part of the unemployment problem was structural. Were there any estimates of the structural component of unemployment or of the so-called natural rate of unemployment in Denmark? To what extent did the generous unemployment benefits in Denmark encourage people to remain unemployed or to slow down the process of job searching? Second, in a small open economy, fiscal stimulus tended to leak out through the balance of payments; in other words, the domestic multiplier was low. Unemployment did not improve much, but, instead, the balance of payments deteriorated because of both higher imports and higher debt service payments abroad. Third, rising fiscal deficits had clearly put upward pressure on real interest rates, which in turn had undermined domestic investment and had led to a shrinking of the manufacturing export-oriented base. That crowding-out effect worked not only through interest rates but also through credit rationing. In the past, when credit had been rationed in Denmark, the private sector had gone abroad for credit, but that was not happening at present.

In 1982, the overall fiscal deficit of the Central Government had reached the worrying figure of 12.3 per cent of GDP, Mr. Casey recalled, and revenue had fallen as a proportion of GDP. Specific duties, surprisingly, had not been indexed, and government expenditure had increased on social welfare and employment support; public sector spending in Denmark was currently 54 per cent of GDP. The authorities had recently introduced "a program for the restoration of the Danish economy." But the first observable element of that program was a further increase in the fiscal deficit of the Central Government: 13 per cent of GDP in 1983 and perhaps higher in 1984. Although the deterioration had been modified by corrective measures, especially on the expenditure side with regard to local authorities, the trend continued in the wrong direction. The restoration program's incomes policy seemed appropriate, but would it be possible to suspend wage and social welfare indexation until the spring of 1985? An increase in personal income tax allowances would make the incomes policy more acceptable, but the relevant question was how large the tax concessions would have to be to win the support of the social partners. If the tax concessions were large, the fiscal deficit could conceivably widen even further.

Monetary policy had been well designed in the past, as others had indicated, Mr. Casey remarked. But it had been gravely undermined by problems on the fiscal side, even though a substantial part of the fiscal deficit was financed in a nonmonetary fashion. Crowding-out of the manufacturing sector seemed to be a very serious problem in Denmark at present. The private sector was not borrowing abroad, perhaps indicating a lack of enthusiasm by entrepreneurs. Fixed investment as a proportion of GDP was not more than 15 per cent, a low figure for an industrial country, despite generous investment incentives provided by the Government. Was a process of deindustrialization taking place? He would appreciate comments on that question and also on any results of business surveys with regard to the nature of the problems in the manufacturing industry as perceived by businessmen.

The sharp increase in the current external deficit to 4 per cent of GDP in 1982 had been caused mainly by increasing aggregate demand, which in turn had been caused predominantly by public consumption, Mr. Casey observed. Although the oil price bill had increased in that period, it did not seem to be the fundamental reason for the deterioration in the balance of payments. Competitiveness had, until recently, been good, a situation that seemed to reinforce the view that the balance of payments pressures were largely caused by excess domestic demand or excess absorption. Such an explanation would account for a high demand for imports, but would not explain why exports had not been more buoyant. Market shares for exports had not grown in 1982 despite a good competitive situation. Was that due to physical capacity limitations and lack of enthusiasm on the part of private sector entrepreneurs, or was it part of the process of deindustrialization?

Some slight improvement in the balance of payments was expected in 1983, but the authorities had to realize that neither the balance of payments position nor the worrying debt service problem would improve significantly until they had taken firm hold of the fiscal situation, Mr. Casey commented, especially as the authorities also aimed at exchange rate stability within the EMS framework. He wondered why the authorities had not tackled the fiscal problem more seriously; was there a belief that oil revenues would some day solve the fiscal problem in a painless way?

He agreed with Mr. Grosche regarding the importance of frequent Article IV consultations, Mr. Casey said. To conclude, he wished to convey his compliments to the Danish authorities on their relatively high level of official development assistance despite their economic difficulties.

Miss Le Lorier observed that it was a challenging task to comment on the documents before the Board, as the Danish authorities appeared to have adhered to the recommendations put forward on March 2, 1981. At that time, the Board had supported a gradual approach toward balance of payments adjustment, and had recommended that fiscal restraint and market determination of private sector wages should be supplemented by a reduction in the relative attractiveness of unemployment benefits. Although the results on the wages and inflation front had been less favorable than expected during the first part of 1982, the economic stabilization program adopted by the authorities and the measures undertaken were a faithful translation of the Board's views in 1981. She shared the thrust of the staff appraisal, but nevertheless she would like to address the more fundamental question of what bearing the present world economic situation should have on the Board's recommendations to Denmark.

The influence of external factors on a small open economy in 1981 and 1982 had been adverse, Miss Le Lorier noted. Table 30 of SM/82/238 indicated that the growth of two items, net imports of energy products and net interest and dividend payments, rightly qualified as intractable in the short run, had offset in 1981 the substantial improvement achieved in the trade balance, excluding energy. Buoyed by the strength of the dollar, the unit value of energy products had risen by 36 per cent, and debt service payments had risen faster than the external debt, the rise in which had been largely the result of exchange rate movements. Another manifestation of the vulnerability to adverse external developments could be found in the extremely high level of real interest rates, which had contributed to the steep decline in fixed investment, but had not been high enough to prevent net private capital outflows. However, notwithstanding the significance of factors beyond their control, the authorities had undertaken to address two major causes of concern: the continued rise in the current account deficit and the continued relatively high rate of inflation.

The main instrument to be relied upon to fight inflation was incomes policy, Miss Le Lorier commented. It was important to note that monetary policy had proved relatively ineffective in combating inflation, despite the preservation of extremely high domestic interest rates and tight domestic liquidity over several years. The authorities had taken ambitious decisions to change even long-standing arrangements; for example, the indexation system had been in existence in Denmark since World War I. Recently, the increases in indirect taxes and energy prices had been excluded from the basis for automatic adjustment. Since 1977, the real disposable income of wage and salary earners had declined consistently. Even so, the authorities had decided to suspend the wage indexation system until the spring of 1985; to suspend the automatic compensation to public sector employees for wage drift in the private sector until 1983, and from April 1983 to limit public sector wage and salary increases to 4 per cent annually until 1985. Moreover, apart from pensions, the indexation of most income transfers had been suspended. She wondered what the impact of those far-reaching initiatives would be on domestic consumption and overall growth in 1983, on the assumption that private wage settlements would observe the same 4 per cent ceiling, according to the staff's own estimates.

The intention of the authorities not to resort to exchange rate adjustment as a means of improving competitiveness was appropriate for domestic as well as international considerations, Miss Le Lorier remarked. There was no need to elaborate on the major drawbacks of exchange rate instability and the dangers of chain reactions. In addition, the various indicators of competitiveness described in SM/82/238, did not seem to show that exchange rate action was warranted. The absence of a further rise in import penetration in 1982 was also relevant in that respect.

Although it might be tempting to ask for even more drastic fiscal restraint than that envisaged, because of the extremely rapid deterioration of the public sector deficit from approximate balance in 1979 to 9 per cent of GDP in 1982, it would not be realistic or even desirable to do so, Miss Le Lorier observed. Mr. Sigurdsson had explained that the Government had had to amend or to replace a number of its proposals on cutting public expenditure in order to obtain parliamentary approval. How did the staff assess any connection between the increase in the fiscal deficit and the preservation of the competitiveness of the export sector? Relatively generous social transfers had greatly facilitated the shedding of redundant labor, and substantial gains in productivity had been achieved despite a sluggish level of activity. The forecast steep rise in interest payments by the Central Government from 5.3 per cent of GDP in 1982 to 7.6 per cent of GDP in 1983 warranted severe restraint in other categories of expenditure merely to stabilize the overall deficit as a ratio to GDP at a time of declining activity, while the cost of external resources and the worrying sharp and prolonged decline in business investment called for a halt to the trend toward increasing the public sector deficit. Fiscal action would have to be pursued over a number of years, and its results would have to be significant.

The preservation of a high level of official development assistance, consisting mainly of grants, the refusal to resort to protectionist measures, and the absence of support for ailing industries were commendable, Miss Le Lorier remarked. Such policies were praiseworthy in present circumstances.

The influence of the international environment could be seen in the relationship between the degree of adjustment and the availability of financing, Miss Le Lorier observed. Denmark had been downgraded from the AAA category to the AA-plus category by investment advisors, but she was not sure of the significance of that event, as no country was being considered at present for upgrading. An important question was whether Denmark could obtain sufficient international financial support to cover the delay until the expected world recovery. It had been noted that the availability of foreign financing was essential to the success of adjustment programs. Perhaps it was worth remarking that sustainable adjustment could not always be associated with an immediate reduction of the current account deficit.

The relation between the degree of adjustment and the size of the economy under consideration was also worth noting, Miss Le Lorier said. On the occasion of the recent consultation with Sweden, Mr. de Groote had suggested that it would not be helpful to push the small open economies further into recession. On the other hand, the size of the fiscal deficit could be an obstacle to the recovery of private investment. But the costs and availability of financing were not the sole determinants of investment, and prospects for overall demand were important. In an environment of sluggish external demand, the preservation of a minimum level of domestic activity was not, a priori, an adverse development as far as investment decisions were concerned.

Her final observation related to the adjustment and policy mix, Miss Le Lorier concluded. Heavy reliance had been placed on monetary policy. High real interest rates had helped in the fight against inflation, but had greatly hindered investment. A significant lowering of interest rates, together with the pursuit of wage restraint through the incomes policies appropriate to each country, would not necessarily result in a rekindling of inflationary expectations. To the extent that fiscal deficits prevented the easing of interest rates, they would have to be curtailed if such a course were followed. But a delicate balance had to be reached between the impact of fiscal restraint on overall demand and the alleviation of the crowding-out effect on the growth of the private sector.

Mr. de Vries remarked that he welcomed the new Danish Government's determination to achieve sustainable growth and higher employment through restraint in real wages and an improved budget position.

He had noted some differences between the staff paper and Mr. Sigurdsson's statement, Mr. de Vries said. For instance, Mr. Sigurdsson had stated that in the current year the fiscal deficit, which would have amounted to DKr 80 billion, without government measures, would be brought down to DKr 69 billion by the authorities' actions. But the staff noted that the deficit would be higher than in 1982, in terms of GNP, and that there was a danger that the ratio might be still higher in 1984. Mr. Sigurdsson had said that, in view of the situation, it was the firm intention of the Government to reduce the budget deficit even further in 1984. Although the two viewpoints were not inconsistent, they gave a different tone, and he hoped that Mr. Sigurdsson would be correct and that the authorities would be able to implement their intentions.

Until recently, the situation had threatened to become unmanageable unless action were taken, Mr. de Vries noted. The Danish authorities had resorted to foreign borrowing as a way out of their difficulties, but interest payments on the foreign debt amounted to some 4 per cent of GNP. While high international interest rates were partly to blame, the fundamental cause of those interest payments was the large amount of borrowing that the Danish authorities had engaged in over the past few years. The authorities' unsustainable path had necessitated the present measures, and perhaps additional action would be required. In addition, very large borrowings, perhaps abroad, would continue to be necessary for a couple of years. In passing, his Netherlands authorities had wondered whether the Danish authorities had at any time given any thought to approaching the Fund.

The steps taken by the Government to improve the budget situation were welcome but, as had been noted by previous speakers and by the Danish authorities themselves, the data underlined the need for further measures, Mr. de Vries commented. In 1982, government expenditures in real terms had continued to rise by 4 per cent. In 1979-82, transfer payments had increased significantly, by 15 per cent in real terms, whereas GNP, also in real terms, had risen by 5 per cent. The large budget deficit had a direct impact on liquidity creation, with liquidity as measured by M-2 rising by 13 per cent in 1982 and by 19 per cent in the 12 months ended September 1982.

Both the call on domestic savings and the balance of payments situation, created in part by foreign borrowing, had led to high real interest rates in Denmark, Mr. de Vries continued. The desirability of lowering real interest rates was another factor that made improvement of the budget situation necessary; otherwise stagnation would continue. Monetary policy had been constrained by the budget situation, and improvement in those two fields would have to go hand in hand.

The suspension of the wage indexation mechanism was an important measure, Mr. de Vries remarked. He hoped that the Danish Government and Danish society would be convinced that higher employment in the long run would only be possible with lower real wages. Moderation in real wages would lead to a healthier situation on the employment front, with wide social and economic implications.

He agreed with the stance of the present Danish authorities on exchange rate policy, Mr. de Vries commented. In the past, Denmark had repeatedly resorted to devaluation, but it was evident that although such devaluations were necessary to restore realistic pricing, devaluation in and by itself did not solve any problems. On the contrary, problems had continued to accumulate both in the budgetary and in the wages fields. He hoped that fundamental adjustment would take place, bringing about more stable exchange rates. He welcomed the Danish contribution to convergence in the European Monetary System, and the decision of the Government not to be pushed off course by the actions that the Swedish authorities had taken recently. The Danish stand against protectionism, both direct and indirect, was also welcome.

The private and industrial sectors seemed to be crowded out by the large government sector and by low profitability, Mr. de Vries noted. The term "deindustrialization" seemed to describe what was taking place; he would like additional information on the efforts of the Danish authorities to improve the general business climate. Their intentions with regard to profitability and, therefore, the lowering of real wages, would be of interest.

His Netherlands authorities were particularly interested in developments in Denmark because the situation was similar, Mr. de Vries said. A new Government had taken office in the Netherlands, two months after the Danish Government, and the Netherlands authorities found the experience of the Danish authorities in dealing with similar problems to be quite pertinent. Mr. Casey had wondered whether oil revenues might be counted on to solve Denmark's problems. The experience of the Netherlands had been that, while oil revenues might help with the external account, they did not help to create a better employment situation; the Danish authorities would have to address the same problems as the Netherlands authorities in order to improve that situation.

Mr. Connors commented that Denmark appeared to be in a worrisome economic and financial situation. The central government deficit was large and was expected to grow further in 1983. The deficit contributed to high real interest rates, and those rates in turn were crowding out private investment. The budget deficit was also putting unwanted pressure on the current account of the balance of payments. Foreign debt was already undesirably large and its continued growth might not be sustainable, given the increased cautiousness of foreign lenders. Since the problems seemed clear, the real question was how the authorities ought best to address them.

He wished to join others in commending the Danish Government for the steps it had taken and those it planned to take to deal with the problems, Mr. Connors said. The suspension of the wage indexation scheme was an important step in the direction of improving competitiveness, which should be helpful in strengthening the balance of payments. But it had to be pointed out that inflation performance in Denmark was worse than the average of its trading partners; if Denmark was to improve its competitiveness through dampening inflation, it would have to bring inflation down below the average of its trading partners, which would appear to be a formidable task. If the authorities were unable to improve domestic wage and price performance to the extent they wished and if, as a result, competitiveness deteriorated, they might wish to reconsider their views on exchange rate policy at a later time, although wage and price restraint would still be needed. He was pleased to learn that, in the event of an unsatisfactory outturn of incomes policy, the Government would consider the adoption of measures to improve competitiveness.

Although the authorities had taken steps to improve the fiscal outlook, the fiscal deficit would remain undesirably large for some time, Mr. Connors observed. The high real interest rates seemed to be crowding out private investment while the high budget deficits were undermining private sector confidence. Over the medium term, if not the short term, such large deficits would have a negative impact on growth and employment. The authorities would have to continue efforts to reduce expenditures and to raise revenues through means that did not exacerbate the disincentive problems that already existed in the Danish tax system.

External sources of finance might become less available to Denmark than in the past, Mr. Connors commented. Foreign lenders were re-evaluating their portfolios of developing country and industrial country debts. Denmark should continue to make efforts at adjustment, so that foreign lenders would continue to make needed external finance available. If movement toward internal and external balance was not perceived by foreign lenders, an undesirably abrupt adjustment might be imposed on the country by external financing constraints.

Mr. Feito said that the staff papers and Mr. Sigurdsson's statement made it clear that the main concern of the Danish authorities over the past years had been the achievement of external balance. As other speakers had pointed out, in a small open economy like Denmark's the room for deviation from the international economic cycle was a narrow one. That feature had been made patently clear in the aftermath of the first oil price increase, when a greater rate of growth of aggregate demand in Demark than in the other industrial countries had led to severe pressures on the current account of the balance of payments and to growing external debt. The response of the economy to the second round of oil price increases had been more efficient. The stabilization measures taken in 1980 had been instrumental in restoring competitiveness as well as in reducing domestic spending, thereby improving the balance of payments situation. However, the short-run adjustment costs of that stabilization effort had proved to be politically unbearable, and in 1981 the course of economic policy had been changed, resulting in a deterioration of the external balance. The economic program of the new Government sought to reverse that deterioration and to restore an adequate growth rate without impairing the external balance of the economy.

He strongly supported the strategy embodied in the Government's economic policies, Mr. Feito stated. The new program correctly identified the binding constraint on the economy as being in the external sector. The aim of the authorities was to implement policies that would ensure not only temporary improvement in the external account but also the achievements of long-run external balance in the economy. To that end, the program relied primarily on policy actions intended to control the growth of wages and the fiscal sector deficit. Those actions complemented each other as the public sector deficit was obviously not unrelated to real wages. The link between real wages and the public sector deficit was particularly strong in a small open economy where the relationship between real wages and exports and employment was a sensitive one. The suspension of the wage indexation system and the limitations on increases in public sector wages and transfer payments were both important measures. Those courageous actions were expected to lead, though probably not in the short run, to a reduction in the overall level of real wages, the only way to achieve lasting gains in competitiveness and to lay the basis for a permanent equilibrium in fiscal finances.

Although the improvement in competitiveness brought about by a lowering of real wages would take some time to manifest itself fully in the balance of payments figures, Mr. Feito observed, a reduction in real wages could also improve the external balance in the short term through its positive impact on private savings and the accompanying reduction of aggregate absorption. In the medium term, if the wage actions undertaken by the Government led to an improvement in profitability, they would also make a dent in the level of the public sector deficit. For that to happen, however, the authorities would have to show determination and persistence in their policies.

To conclude, it should be clear that given the current state of the international economy, there was no alternative to the policy course that the Danish authorities intended to follow, Mr. Feito commented. Any artificial stimulation of the economy would only result in short-run and temporary gains in income at the expense of both a deterioration in the balance of payments situation and increased external indebtedness. The authorities were fully aware of the situation and should be commended for incorporating the constraints imposed by the international economy into their program. He complimented Denmark on its fairly high levels of aid flows to developing countries and on its open trade system.

Mr. de Groote said that Denmark's experience in 1981 and 1982 cast a particularly clear light on the limitations of economic policies in small open economies. In such economies, exports and imports represented a large share of GDP; external events, therefore, had a powerful effect on domestic developments, which in turn had an immediate effect on the external balance. The case of Denmark highlighted the dilemma faced by small open economies whose policy objectives were in disagreement with those of the major economies. The pursuit of expansionary fiscal policies while major neighboring countries were following restrictive economic policies was bound to have pronounced negative effects on the balance of payments. Those constraints appeared more clearly at present due to the unprecedented simultaneous pursuit of restrictive policies by the major countries. Therefore, the option of fiscal expansion had to be ruled out for a small country with external disequilibrium.

An expansionary policy based on exchange rate adjustment was quite impractical in an international environment of low growth, Mr. de Groote remarked. A large expansion of export market shares would be necessary to boost growth rates enough to reduce the high unemployment rate. Under zero-growth or low-growth conditions, the expansion of market shares could only be immediately accomplished by competitive devaluation. The Danish authorities were to be commended for not having taken that path, although the temptation and the opportunities to do so were present. Such an approach would have had strongly destabilizing effects on the European Monetary System. As the Danish authorities considered that the country possessed a sufficient competitive edge, and the most helpful use of exchange rate adjustment was in the struggle against inflation, they were committed to keeping the exchange rate fixed. With that commitment, monetary policy was directed toward maintenance of the external situation. Room for maneuver in that area would thus depend very much on developments abroad. By imposing those policy limitations on itself, the Danish Government had deliberately excluded the possibility of pursuing expansionary policies, which was not the easiest course under conditions of high unemployment, leaving incomes policy and fiscal policy to arrest the deterioration of the external and fiscal situation.

It would be impossible to reduce the disequilibria in the short term without serious deflationary effects, which would be unacceptable in present conditions, Mr. de Groote remarked. Considering their extremely limited options, the authorities seemed to have drawn the appropriate conclusions and had tried to limit the growth of money wages mainly through the suspension of the indexation mechanism and a temporary freeze on wages. They had also set a maximum rate for wage increases in the public sector, which was to serve as a norm for the private sector as well. It was to be hoped that the guidelines would be accepted in wage negotiations so as to permit a further improvement in the profitability of enterprises. He wondered what measures the Danish Government could take in case the actual outcome of wage negotiations was less positive. On page 9 of SM/82/229 the staff had referred to the adoption of alternative measures, but without elaboration; he would appreciate further comment on that point. The containment of money wages was essential if Denmark was to maintain its competitive advantage and continue to improve its external balance. Heretofore, the improvement in relative wage costs had permitted the reconstitution of profit margins, which might, if maintained long enough, fuel a recovery in investment over the medium term.

Since 1979, Denmark's gain in competitiveness had been substantial and had led to a marked improvement in export performance and increased market shares for Danish exports, Mr. de Groote noted. The geographical distribution of exports showed a large increase to the United States and the OPEC countries, while commodity distribution showed gains in manufactures. That expansion had begun to slow down in 1981 and had continued to do so in 1982, mainly as a result of the recession and apparently not as a result of a loss of competitiveness. He would appreciate more specific information on the shift in the commodity composition of foreign demand to the disadvantage of Danish firms, referred to in the paper on recent economic developments.

The reduction in private domestic demand, leading to a further dampening of economic activity, would obviously have a negative effect on fiscal revenue, Mr. de Groote observed. Thus, improvement in the fiscal balance was bound to become even more difficult, especially as some of the increase in fiscal outlays was due to structural factors, such as net interest expenditure related to the growing external debt. Under those conditions, there could be little improvement in the fiscal deficit, even if vigorous action were taken to limit expenditure. Nevertheless, the authorities were strongly committed to improving the budget situation, including cuts in social security benefits if necessary, since they viewed fiscal improvement as a prerequisite to the recovery of private investment. The adjustment efforts in the fiscal area would be assisted greatly if external world demand would give full scope to Denmark's competitive advantage; the private sector could thus expand and compensate for the necessary contraction of the public sector.

In the medium term, the fiscal prospects could be greatly influenced by the development of the oil and gas sectors, whose output Denmark expected to continue to increase until the end of the decade, Mr. de Groote remarked. The options at the authorities' disposal to deal with the present deficit could be quite different, depending on whether large fiscal revenues could be expected from oil and gas development. He would appreciate some comment by Mr. Sigurdsson on what was expected in that area. The development of the energy sector and the appearance of a more favorable world economic environment would be invaluable in helping Denmark to achieve a more rapid adjustment and the resumption of economic growth. More important, any lasting improvement in Denmark's position would largely depend on a continuously effective incomes policy and a sustained improvement in the budgetary position.

Mr. El-Khouri recalled that during the past few years, the Danish economy had suffered from economic difficulties caused by external factors as well as by domestic maladjustment. The difficulties had become particularly pronounced in 1982, for which estimates showed an inflation rate of 10.6 per cent, an unemployment rate of 9.6 per cent, a central government budget deficit equivalent to 12.3 per cent of GDP, and a current account deficit equivalent to 4 per cent of GDP. The adjustment effort undertaken in 1980 had been hampered by a worsening in the international economic situation.

The new Government that had taken office in September 1982 had launched a bold program to tackle the existing imbalances in the economy, and should be commended, Mr. El-Khouri remarked. The most significant part of the program was incomes policy. The suspension of the wage and salary indexation scheme and the adoption of the 4 per cent norm for wage increases constituted major steps to slow down the increase in costs and prices in order to bring them down to more competitive levels. It was to be hoped that the unions would be able to agree to that norm. The Government had also taken direct fiscal action to limit the increase in expenditures and to raise revenues during 1983.

Given the rapid increase in the fiscal imbalances in recent years, the Government could, realistically, only hope initially to arrest the rise in those imbalances, not to reverse them, Mr. El-Khouri commented. For example, despite the fiscal measures, the ratio of the central government budget deficit to GDP would still be 13 per cent in 1983. It was therefore important for the Government to continue with its fiscal adjustment efforts over a number of years, and to pursue that effort with vigor.

He wished to commend the authorities for their excellent record on official development assistance, Mr. El-Khouri concluded. ODA flows had risen to 0.73 per cent of GNP in 1981, exceeding the target of 0.7 per cent of GNP for the fourth consecutive year. The targets for official development assistance had been set at 0.73 per cent of GNP for 1982 and 1983 and slightly higher for 1984, despite budget difficulties, representing a fine example of international cooperation. It was to be hoped that other industrial countries would emulate Denmark's efforts.

The staff representative from the European Department remarked that incomes policy was at the heart of the Government's strategy. The authorities had eliminated indexation of wage contracts until at least the spring of 1985, and the move had apparently been accepted in the labor market. Nevertheless, it was impossible to predict with any certainty the outcome of the next round of wage negotiations. The Government was determined to hold the line in the public sector, but some wage drift--which had been referred to in the staff report--was likely to occur in the private sector, although even there the weak labor market should limit the extent of any drift. During the discussions in Copenhagen, the authorities had indicated that an increase in private sector wage earnings of the order of 5-5.5 per cent might well occur, rather than the 4 per cent to which they hoped to hold wage adjustment in the public sector. The staff felt that there was some risk that wage drift would be slightly higher than the authorities had suggested. If the increase in wages in the private sector were actually held to 4 per cent, as the authorities hoped, private consumption would be somewhat weaker in the short run than was now expected, but the rate of inflation would decrease somewhat faster.

The question had been raised, the staff representative recalled, whether the income tax cut that had been promised in return for a satisfactory wage settlement would not worsen the budget position. A tax cut of the order of DKr 2.5 billion--equivalent to about 0.5 per cent of GDP--was included in the budget estimates. Hence, if the wage settlement were satisfactory, the budget estimates would not be affected. If the wage settlement were unsatisfactory, the income tax cut would not be implemented, and the budget position would therefore be somewhat stronger than it would have been otherwise. The authorities had stated that if wages rose more quickly than they hoped, they would keep an open mind on changing the exchange rate, but they had no intention of trying to improve Denmark's competitive position by taking unilateral exchange rate action within the European Monetary System.

It was extremely difficult to disentangle the cyclical components of unemployment in Denmark from the structural ones, the staff representative remarked. The increase in unemployment from about 6 per cent in 1979 to more than 9 per cent in 1981 had been related to the decline in GDP in that period. The decline in both output and employment had been particularly pronounced in the construction sector, and the difficulties in that sector largely reflected structural adjustment. In general, however, the increase in unemployment in 1979-81 had been caused by a mixture of cyclical and structural factors, reflecting domestic adjustment to the oil price rise and the unfavorable external environment.

The staff had no estimates of the effect of the relatively attractive benefits on the level of unemployment, the staff representative explained. The authorities were, however, concerned about such effects, and their recent decision to freeze the nominal value of unemployment benefits reflected their concern.

The share of manufacturing in GDP had shrunk during most of the 1970s, the staff representative noted, while the share of the sheltered sectors--particularly of the public sector--had increased. In 1980-81, however, the share of manufacturing had increased, mainly because of the improvement in the competitiveness of Danish industry and the associated gain in export market shares. Nevertheless, the share of business fixed investment--which also included investment of the sheltered sectors--in GDP had fallen as a result of weak demand and high real interest rates. The business sector was still worried about the existing high level of real interest rates.

There had been no capacity constraint on exports, the staff representative explained. Danish exports were concentrated on investment goods and consumer durables, which were cyclically more sensitive than other components of demand. Hence, the staff's measure of export market growth, which was based on total imports, might not adequately reflect the actual developments in Danish export markets, as the staff itself had mentioned in its report on recent economic developments. The growth of export markets might well have been more sluggish than the staff figures suggested; that exports had not risen more rapidly than they actually had was probably due to the considerable weakness in foreign demand for investment goods and consumer durables.

The staff could not be certain about the absolute level of competitiveness of Danish industry, the staff representative said, but all the usual measures, such as relative unit labor costs and relative export prices, showed that the competitive position was stronger at present than at any time in the 1970s.

The question had been raised, the staff representative from the European Department recalled, whether future oil revenues would not significantly ease the adjustment effort. Oil revenues had amounted to DKr 0.2 billion in 1982 and were likely to rise to about DKr 0.4 billion in 1983, the equivalent of only about 0.25 per cent of total revenues. The authorities had been unable to provide estimates of oil revenues beyond 1983, but it seemed certain that, while the revenues would increase, they would not reach a level that would significantly contribute to fiscal adjustment over the next few years. Finally, some of the general questions that Miss Le Lorier had raised might best be dealt with during the coming discussion on the World Economic Outlook.

Mr. Sigurdsson noted that the staff had supported the thrust of the Government's program, and that Executive Directors seemed to have accepted the staff appraisal.

It was useful, Mr. Sigurdsson continued, to compare the Chairman's main recommendations in his summing up of the discussion on Denmark in March 1981 (EBM/81/32) with the policy actions that the authorities had recently taken. During the previous discussion, a number of Executive Directors had recommended that fiscal restraint be supplemented by further modifications of the system of wage determination and by a reduction in the relative attractiveness of unemployment benefits. The Government had recently taken three steps to strengthen competitiveness and to reduce both the current account deficit and inflationary pressures. First, it had introduced domestic wage restraint by suspending wage indexation, temporarily freezing wages, and introducing guidelines for wage and salary developments in the coming two years. Second, the Government had reduced public sector expenditure, including various social transfers. Third, the authorities had maintained a stable exchange rate policy within the framework of the European Monetary System. The authorities believed that together those steps would reduce the relative cost level of Danish industry, lower interest rates, and diminish the tax burden.

Incomes policy was clearly at the core of the Government's program, Mr. Sigurdsson remarked. The authorities were relatively optimistic that the wage norm would be observed, although at the present stage it was too early to know for certain what the outcome of the ongoing wage negotiations would be. The authorities believed that the wage guidelines had a reasonable chance of being adhered to in 1983. They had stressed that wages were determined through free bargaining, and that the 4 per cent norm was not an absolute or fixed one for all decisions, but rather a guideline.

It was certainly true, Mr. Sigurdsson said, that the present general situation in the financial markets underscored the need for adjustment. In that connection, the recent change in Denmark's international credit rating by one of the rating agencies from AAA to AA-plus might not be particularly important. The authorities felt that the change was unwarranted and regrettable, but they had publicly stated that the change constituted a warning signal that should be taken seriously by the economic decision makers in Parliament and the labor market.

The stabilization program, Mr. Sigurdsson explained, was to be supplemented by measures designed to restore market incentives and to stimulate economic activity and investment. The Government had recently presented a proposal for containing the growth in the rate of unemployment benefits and certain other social security benefits. The authorities intended to stimulate investment mainly by improving the general business climate. Priority in education and research was to be given to business-oriented technology and product development. In particular, there was to be an increase in research into the areas of energy and information technology. The authorities also intended to simplify or eliminate a variety of regulations governing the operations of private enterprises, with a view to reducing costs and administrative difficulties.

Investment in infrastructure--particularly in transportation, energy, and telecommunications--was to be stepped up, and tax regulations governing the financial markets were to be adjusted in order to stimulate the flow of risk capital to the business sector, Mr. Sigurdsson went on. For instance, the authorities wished to offer personal tax benefits for investment in equity and to ease taxation for dominant shareholders who wished to sell their shares. The authorities were also considering other tax measures to improve the liquidity position of enterprises and to provide them with incentives for investment. The Government intended to permit competitive private firms to take over various services--such as laundry service, catering, and laboratory work--that were now provided by public bodies. The investment program also contained initiatives to expand investment and production in the private oil and gas sector and to encourage an increase in the supply of electricity. The budgetary impact of the measures under the investment program would be limited. Of course, such measures took time to implement and to take effect.

The present high interest rates in Denmark were clearly an impediment to investment, Mr. Sigurdsson commented. That was generally the case for real interest rates, although real interest rates after taxes did not always constitute a disincentive. The tax deductibility of interest rate payments and the so-called K-loans, which involved a considerable interest rate subsidy for industrial investment, were important factors in the investment area. The level of nominal interest rates in Denmark was therefore not a particularly significant element of investment activity in the country.

Since the new Government had taken office in September 1982, Mr. Sigurdsson said, interest rates in the capital market had fallen by two-and-a-half to three percentage points. Bank lending rates had fallen in response to the 1 per cent reduction of the Nationalbank's discount rate on November 30, 1982. The present bank lending rates in Denmark were nearly in line with comparable rates in other deficit countries. However, interest rates in the long-term bond market were still much higher in Denmark than abroad; that long-standing problem had been caused by a combination of several factors, including the relatively high inflation rate in Denmark, the tax treatment of interest rate payments in Denmark, and the country's persistent balance of payments and fiscal deficits.

It was of course true that the public sector was an important element in the setting of economic policy in Denmark, and that there was a clear need to curb public spending, Mr. Sigurdsson said, but there was also an urgent need to examine carefully attitudes toward government deficits in Denmark and other countries. Deficits should be judged in the light of the economic cycle and of the behavior of savings and other important economic factors. Appropriate structural policies and expenditure restraint were obviously needed in many countries, but the Fund should make an effort to improve its analysis of members' budget deficits and other fiscal issues.

The authorities' present course of action was courageous and difficult, Mr. Sigurdsson commented. The Government would have to make a persistent effort over a long period if the adjustment program was to be successful. Developments in the world economy would obviously play a crucial role in determining the ease with which the needed shift of resources to improve the balance in the economy could be achieved. The authorities believed that to gain a substantial and lasting reduction in the external current account deficit, the growth of wage costs would have to be much slower than in the recent past, and that there would have to be continued improvement in the budgetary position of the public sector.

The Chairman then made the following summing up:

> Executive Directors noted that external adjustment had succeeded in reducing Denmark's current external deficits in 1980 and 1981, although at the cost of higher unemployment. The degree of adjustment had been insufficient to reduce the high external debt service ratio. In 1982, the external adjustment had come to a halt largely because fiscal policy took a more expansionary turn; the budget deficit rose sharply because of, inter alia, large and rising interest expenditure and higher public sector

wages. The revival of domestic demand in 1982 had led to increased imports, while export growth had been hampered by weak demand abroad. These developments, together with further increases in interest costs on foreign debt, had led to a renewed widening of the current account deficit. At the same time, wage pressures had risen again, and the rate of inflation had remained high.

Against this background and the prospects for a further worsening of the imbalances in the economy, the new Government that took office in September 1982 had immediately adopted an economic stabilization program.

Directors welcomed the thrust of the measures, which are designed to reverse the existing trends and, thus, to reduce inflationary pressures, improve competitiveness and the external balance, and lay the basis for restoring satisfactory growth and employment in the longer run.

Directors commended the Danish authorities for suspending the indexation of both wages and most social benefits until 1985 and for aiming at low nominal income settlements in the next two years. They agreed that domestic wage restraint for improving competitiveness was necessary. Several Directors highly commended the determination of the authorities to resist unilateral devaluation. Such an action might have had adverse international repercussions. In Denmark it could have undermined the basis for securing a lower rate of growth of nominal incomes and would also have rendered the reduction of inflation more difficult. In the same vein, the resolve of the Danish authorities to resist protectionist measures as well as aid measures for ailing industries was warmly welcomed.

Nevertheless, Directors expressed their concern that despite the new measures the public sector deficit was expected to rise to a higher level in 1983 and beyond and was leading to a crowding out of the enterprise sector in the financial markets. This huge deficit was contributing to the high level of real rates of interest, which, together with sluggish foreign demand, had discouraged business fixed investment.

Directors felt that an enlargement of the exposed sector and the achievement of satisfactory economic growth in the future were unlikely unless real interest rates could be reduced. They believed that while the Government's present program was a step in the right direction, more would clearly have to be done in order to remove the imbalances in the economy. Directors, therefore, welcomed and put emphasis on the Government's firm intention to take further fiscal action to reduce the public sector deficit and to rely for this purpose on expenditure cuts as much as possible. Directors stressed that too slow an adjustment over too long a period could endanger the prospect of achieving durable external adjustment and of reducing the large external debt burden. In this context, the very high level of public sector expenditure--some 54 per cent of GDP--was noted. Therefore, they called for an early and significant reduction in the budget deficit from the high level envisaged for 1983, which they judged excessive. This, in turn, would facilitate the conduct of an appropriate monetary policy.

Denmark was commended for the progress made in the field of energy policy, which resulted from both energy conservation and the development of offshore oil and gas resources and which would contribute to external adjustment in the coming years.

Several Directors praised Denmark's development assistance program, which was among the few exceeding the United Nations target level of 0.7 per cent of GDP, despite the current economic difficulties.

Finally, the importance of more frequent Article IV consultations with Denmark was stressed.

4. EXECUTIVE DIRECTOR

The Chairman bade farewell to Mr. Sigurdsson upon completion of his term as Executive Director.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/83/9 (1/10/83) and EBM/83/10 (1/12/83).

5. KENYA - 1982 ARTICLE IV CONSULTATION - POSTPONEMENT

The Executive Board notes the request contained in EBD/83/8 (1/7/83). Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to postpone its consideration of the 1982 Article IV consultation with Kenya until not later than March 14, 1983.

Decision No. 7303-(83/10), adopted
January 11, 1983

6. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 82/95 through 82/97 are approved. (EBD/83/6, 1/5/83)

Adopted January 11, 1983

7. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/83/11 (1/7/83), and by an Advisor to Executive Director as set forth in EBAP/83/10 (1/7/83), is approved.

APPROVED: June 22, 1983

JOSEPH W. LANG, JR.
Acting Secretary