04

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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/42

10:00 a.m., March 2, 1983

W. B. Dale, Acting Chairman

Executive Directors	Alternate Executive Directors
	M. K. Diallo, Temporary
	C. Taylor
	P. Péterfalvy, Temporary
	P. D. Péroz, Temporary
	M. Teijeiro
R. D. Erb	
	M. A. Janjua, Temporary
	Jaafar A.
T. Hirao	
	M. Casey
	C. Robalino
	G. Grosche
	C. P. Caranicas
	A. S. Jayawardena
	J. E. Suraisry
J. J. Polak	
A. R. G. Prowse	K. G. Morrell
G. Salehkhou	O. Kabbaj
F. Sangare	
	E. Portas, Temporary
J. Tvedt	
Zhang Z.	

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

Also Present

European Department: L. A. Whittome, Counsellor and Director; B. Rose, Deputy Director; M. T. Hadjimichael, S. M. Thakur. Exchange and Trade Relations Department: S. Mookerjee, Deputy Director. Fiscal Affairs Department: G. Blöndal, R. Hurnard. Legal Department: A. O. Liuksila. Research Department: G. H. Spencer. Advisors to Executive Directors: A. A. Agah, E. A. Ajayi, J. R. N. Almeida, I. R. Panday. Assistants to Executive Directors: E. M. Ainley, R. Bernardo, J. Bulloch, L. E. J. Coene, T. A. Connors, R. J. J. Costa, I. Fridriksson, P. Leeahtam, W. Moerke, V. K. S. Nair, Y. Okubo, J. K. Orleans-Lindsay, G. W. K. Pickering, J. Reddy, J. Schuijer, D. I. S. Shaw, H. Suzuki, M. Toro.

1. NEW ZEALAND - 1982 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1982 Article IV consultation with New Zealand (SM/83/19, 1/24/83). They also had before them a report on recent economic developments in New Zealand (SM/83/22, 2/3/83).

Mr. Morrell made the following statement:

I would like to express the appreciation of my New Zealand authorities to the staff for its constructive approach to the discussions recently held in Wellington, and for the comprehensive set of papers. I know that my authorities gained a great deal from the full and frank exchange of views with the staff mission team. The staff papers provide a well-balanced assessment of recent developments in the New Zealand economy with which my authorities are in broad agreement.

There are a few areas where some further remarks may be helpful.

The wage-price freeze dominates economic developments in New Zealand at the present time. The imposition of the freeze follows a number of years during which the New Zealand authorities made significant efforts to free up the economy and stimulate export growth. There was a major freeing up of controls on the financial system after 1976. A policy of flexible adjustments to the exchange rate to broadly offset changes in relative price levels between New Zealand and its major trading partners was introduced in 1979, the authorities adopted an aggressive policy of marketing its debt instruments during 1979/80 in order to finance its fiscal deficit in a noninflationary way.

As the staff notes, these policies resulted in a reduction in the external current account from 3.75 per cent of GDP in 1979/80 to 3.25 per cent in 1980/81, despite a drop of 10 per cent in the terms of trade. Inflation, however, remained high. Encouraged by the reduction in the current account deficit, and concerned at the rising levels of unemployment, the authorities relaxed monetary conditions during 1981.

With further inflationary injections from abroad and a high level of wage settlements, these policies resulted in a stimulus to domestic activity but a worsening in the current account deficit in 1981/82 and no improvement in the rate of inflation.

The New Zealand authorities were concerned at the high level of domestic inflation in 1982, particularly in the face of slowing price rises in the country's major trading partners. After failing to achieve consensus with the trade unions on a wage-tax trade-off, the authorities declared a one-year freeze on wages, prices, and other forms of income. They placed comprehensive ceilings on deposit and lending interest rates, and fixed the effective (trade-weighted) exchange rate for a year at its June 1982 level. The authorities also announced a large cut in personal income taxes in the 1982/83 budget as a partial offset to the effect of the income freeze on real wages.

There are now signs that the freeze is having the desired effect of containing prices and holding wages, and the authorities are determined not to allow any significant breakout of inflation following the scheduled end of the freeze. They recognize that this will be the most crucial test of the success of the freeze. To ensure there is no resumption of high wage increases, they have instituted tripartite discussions involving the unions, employers, and government representatives with a view to trying to reach a consensus on satisfactory arrangements for postfreeze wage determination. It is too early to tell if these talks will prove successful, but, come what may, the authorities are determined that the situation will not be allowed to get out of control.

The authorities realize that tight monetary conditions and acceptance by the community that restrictive conditions will persist is necessary if inflationary expectations are to be dampened. They are determined that the tight monetary conditions that developed during 1982 will be maintained in the period ahead. To this end, they intend to keep public sector security ratios on financial institutions at relatively high levels; for example, reserve asset ratios on trading banks have risen from 10 per cent of deposits in November 1982 to 30 per cent of deposits for March 1983. The Government also intends to compete aggressively for funds from the private sector in order to finance its deficit in the least inflationary way.

Although acknowledging that there will be some short-term distortions resulting from the imposition of interest rate controls, these controls are seen as an integral part of the wage-price freeze since they directly affect an important source of income and cost. For this reason the removal of the controls will be dependent on the outcome of the present tripartite negotiations on income determination. An relaxation will be made only in the context of the overall policy approach ultimately adopted for the country's emergence from the present freeze period.

The controls are not as severe as the staff papers suggest, although they are certainly comprehensive. They were not responsible for the development of negative real interest rates, since the controlled rates broadly reflected market rates at the time of their promulgation. What is more, in the last few months many lending and deposit rates have moved below the ceilings in response to generally slack demand conditions and an ample supply of funds. Thus there is now room for upward flexibility in the movement of market interest rates under the ceilings. Nor can it be said that the controls have prevented or will prevent the authorities from competing in the market for funds at rates above those which institutions are permitted to offer.

While no decision has yet been made on the exchange rate policy to be adopted in the postfreeze period, the authorities are fully aware of the need to provide continued stimulation to the development of export-oriented industries.

Partly under the influence of the freeze, and particularly its effect on real wage levels, economic activity slowed markedly in the September and December quarters of 1982. There are now one or two indications that the contraction in final domestic demand may have bottomed out, although little pick-up in output is expected in the March and June quarters of 1983 as firms continue to adjust their stock positions and wait for confirmation of a sustainable increase in demand.

The rate of inflation has slowed significantly from the annual rate of 16 per cent recorded in the six months to June 1982, reflecting the influence of the wage-price freeze, the slowdown in activity, tighter monetary conditions, and more stable import prices (in part the result of the exchange rate freeze). The increase in the consumer price index for the December 1982 quarter was 2.7 per cent, the lowest quarterly increase since the March 1979 quarter. A further improvement is expected when the March 1983 figure is available.

The New Zealand authorities acknowledge the need for adjustment in the areas of government expenditure and taxation. In addition to the reform of the taxation system, a major medium-term objective in the public finance area is a slowdown in the growth of public expenditure based on a reassessment of spending objectives and the application of principles consistent with the overall efficiency of the economy.

The authorities have been actively pursuing policies aimed at freeing up the economy from protection and making New Zealand manufactured exports more competitive worldwide. A system of tendering for import licenses was introduced in 1980, and is being expanded. A series of industry studies has been initiated to review the levels of protection afforded to various key industries. One result of these studies has been the phasing out of licensing in the plastic industry over six years. The recent signing of the Closer Economic Relations Agreement with Australia is seen as a significant step in the liberalization of New Zealand's system of protection and export incentives.

A difficulty that the authorities face in implementing policies of import liberalization is the widespread knowledge within the country of the difficulties New Zealand faces in marketing its primary products overseas. The degree of agricultural protectionism faced by New Zealand exports is outlined in the appendix to SM/83/22, and an indication is given of the quantitative effect of these constraints. My New Zealand authorities continue to be concerned at the damaging effect that protectionism is having on the access to markets of not only its own primary produce but those of other primary produce exporters as well.

The authorities have been promoting the development of major energy-based projects. These projects, which exploit the country's considerable energy resources including large reserves of natural gas, are expected to reduce New Zealand's dependence on imported oil as well as generate significant export earnings. Although the staff paper notes that the projects will make a positive contribution to the balance of payments by 1986/87, they will in fact be generating foreign exchange earnings from 1982/83. The projects are expected to allow New Zealand to become 50 per cent self-sufficient in transportation fuels by 1987, compared with about 10 per cent at present. Despite the present prospect of falling oil prices, the authorities are confident in the long-term viability of the energy projects.

The New Zealand authorities are keeping a close watch on the level of overseas borrowing required to support the present level of investment in the major projects. They are satisfied that the present requirements can be readily financed, and that the projected foreign exchange paybacks from the projects together with the anticipated benefits from other restructuring policies will enable the expanding debt volume to be serviced comfortably.

My authorities have suggested that some aspects of the staff's description of wage-price policies could be clarified. General wage increases are not an integral part of the wage-fixing system, as seems to be implied on page 7 of SM/83/19. The legal basis of general wage orders was repealed in 1979, since which time there have been two government-awarded increases and a one-off court hearing.

While it may be true that on some estimates there is a "real wage overhang" of more than 12 per cent over the decade up to 1980/81, this very much depends on the choice of productivity and real wage series and of the base and terminal periods. The GDP/employee growth rates during the 1970s seem to be unduly low in comparison with other indicators, possibly because of changes in the composition of the labor force. Furthermore, any real wage gap comparison tends to show real wage increases outstripping labor productivity (adjusted for the terms of trade) if the base period is in the range 1963/64 to 1969/70, but no gap, or a negative gap, if the range chosen is outside this period.

In conclusion, I would like to reiterate my authorities' gratitude for the effort that the staff has put into the 1982 Article IV consultation with New Zealand, and for the comprehensive analysis provided. The knowledge gained by the authorities will be valuable in developing appropriate policies to deal with the country's problems in the years ahead.

Mr. Taylor noted that it had been two years since the previous Article IV consultation with New Zealand, a period that seemed rather long for an OECD country. He hoped that the next interval would be shorter.

On the substance of the matter, Mr. Taylor stated that there was little in the staff appraisal with which he would strongly disagree. The current account position had weakened markedly in the past year or so, with the 1982 deficit being double that of 1980, and the trade account, traditionally in surplus, moving into deficit. Naturally, to some extent the deterioration could be traced to the weakness in the world market, which certainly accounted for quite a large proportion of the worsening of the terms of trade, which had amounted to some 15 per cent during the past three years. The adverse movements had finally outweighed the effects of a relatively successful policy of diversification into new export markets, which had been pursued in the decade or so since the United Kingdom had joined the European Community. Moreover, the New Zealand economy was almost wholly dependent on imported oil. Indigenous energy products were being developed, but, in the short term, the necessary imports had tended to put pressure on the trade balance.

The authorities had been looking to the international capital markets both to finance the energy developments and to make compensatory external borrowings to accommodate the consequences of a period of excessive domestic demand and high domestic costs, Mr. Taylor noted. The deterioration in the external account, which had taken place in a period of rising unemployment, was symptomatic of a serious lack of competitiveness. In recent years, the rate of increase in New Zealand's prices and costs of production had been substantially higher than that of its major competitors, and for the most part the exchange rate depreciation had barely been able to offset the differential, as Chart 4 in SM/83/19 clearly showed. The rate of inflation in New Zealand had been somewhat over 15 per cent at an annual rate at the end of 1982, compared with a rate of about 7 per cent in the rest of the OECD area at that time.

Gradual and voluntary approaches to containing the growth of domestic costs having apparently failed, Mr. Taylor went on, the Government had introduced a wage and price freeze in an effort to break inflationary expectations. While such an approach was courageous and might have valuable short-term effects, it was likely to raise almost as many problems as it might temporarily overcome. It was far from clear, for instance, that the trade unions would refrain from demanding wage increases to catch up, once the freeze ended in June 1983. Moreover, the rigidities that were always inherent in a wage and price freeze tended to create their own serious problems of comparability, and they were notoriously difficult to erase in the period following the end of the freeze. A number of small OECD countries, like Israel and Iceland, seemed to have had such experiences, as indeed had the United Kingdom in the 1960s. While the staff was quite right in observing that the rigidities tended to come about as a quid pro quo in the course of achieving consensus and cooperation among the social parties, they did tend to enhance the desire for parity and equal treatment among wage bargainers, something that could be difficult to handle. Naturally, the authorities were well aware of those difficulties, and Mr. Morrell had indicated that they intended to take determined action at the appropriate time. He would be particularly interested to see the outcome of the tripartite talks on the postfreeze wage determination system.

He had understood that the introduction of the wage freeze was a reflection of the authorities' intense desire to avoid untoward increases in unemployment that might arise from a stronger demand management effort to deal with the structural problems, Mr. Taylor stated. Unfortunately, in many economies, efforts to keep unemployment down to comparatively low levels seemed to create inflationary pressures and to hamper adjustment efforts. In the longer run, as the structural rigidities and inefficiencies became more apparent, unemployment might even become higher than it would have been if the authorities had followed more vigorous policies earlier.

On the fiscal side, Mr. Taylor observed, the tax measures that had been offered as a quid pro quo for the wage freeze went some way toward improving a situation in which by far the majority of income tax payers had been in high marginal tax brackets. The approach was probably a sound one. He also agreed with the staff that there might be a case for shifting the tax base from direct to indirect taxes by the introduction of a value-added tax (VAT) or a broad-based sales tax, although of course care would be needed to ensure that the shift did not set back the efforts to control inflation.

Wage and income freezes typically attracted a panoply of other controls or regulation, sometimes including regulation in the monetary field, and the same thing seemed to have happened in New Zealand, Mr. Taylor remarked. The control of interest rates, which had been in force since 1981, had apparently led to the imposition of negative rates in many cases. That was a retrograde step in view of the need to broaden the domestic capital market and enable the budget deficit to be financed to a greater extent by sales of debt instruments to domestic nonbank agents. He had been interested in Mr. Morrell's view that the interest rate controls themselves had not been responsible for the negative real interest rates, on the grounds that market rates had moved conspicuously lower in recent months. If indeed the controls were not responsible for the low interest rates, if was difficult to see why they were considered an integral feature of the incomes restraint policy, or why their removal would be difficult.

The exchange rate policy followed from 1979 until June 1982 of making fairly regular adjustments in the exchange rate had enabled New Zealand to avoid losing competitiveness against its trading partners, Mr. Taylor considered. While the new and less flexible approach that had been followed might be helping to counter inflation, it could be damaging to the external prospects of New Zealand at a time when the country particularly needed to preserve its share of external markets. The burden of adjustment required in the domestic field would be all the greater if the exchange rate was not allowed to move in a direction that would provide at least some correction for the adverse trend of relative costs.

After the series of current account deficits, the mounting level of external debt was beginning to give cause for serious concern, Mr. Taylor observed. The rise in the cost of debt servicing had been particularly severe in 1982, and the current account had deteriorated accordingly. The staff had given figures only for official debt, and even they were fairly out of date; he wondered whether the staff was in a position to say anything on the current situation. Reports in the New Zealand press had suggested that by the end of 1982 the extenal debt had amounted to about US$10 billion, of which US$7.5 billion was official debt, a considerable increase from the previous year. The debt service ratio seemed to be close to 20 per cent and would probably rise still further by the end of 1983. The situation seemed to have deteriorated since the beginning of 1982, and the staff might be understating the matter in saying that "the authorities should be watchful of the evolution of foreign debt."

He agreed with the staff that it would be desirable to replace, as far as possible, the system of import licensing by one of uniform tariffs, or at the least to increase the scope of competitive tendering arrangements for licensing and to reduce the scale of export subsidies, Mr. Taylor stated. Such changes would help the budget situation. The agreement on closer economic relations with Australia was a welcome development and should help to give an impetus toward reducing protection. The authorities might even consider whether similar agreements with other regional trading partners might be sought.

He welcomed New Zealand's move to Article VIII status in 1982, Mr. Taylor stated. In passing, the New Zealand action meant that 18 out of the 20 countries classified as "industrial" in International Financial Statistics had now assumed Article VIII status.

While the staff had well outlined the major economic problems facing New Zealand, it had perhaps understated the seriousness of the situation now developing, Mr. Taylor considered. The continuation of certain policies might be storing up difficulties for the future. Many countries had found that the longer adjustment was postponed, the tougher the corrective measures would have to be. Like many OECD countries, not least the United Kingdom, New Zealand seemed to be facing problems that were largely structural, and they would take time and persistence to correct. The authorities should therefore move ahead with the necessary measures as soon as possible.

Mr. Jaafar remarked that the growth rate of the New Zealand economy had declined sharply from 4.4 per cent in 1981/82 to a rate of -2 per cent in 1982/83, and that growth was expected to remain stagnant in 1983/84.

Unemployment had risen equally sharply from 5.5 per cent in 1981/82 to about 7 per cent in 1982/83 and was expected to rise further to about 8 per cent in 1983/84. The growth in consumer prices had been about 15-16 per cent per year for the past several years. The external position had also been weak, with a current account deficit amounting to $NZ 1.58 billion in 1981/82 or 5.5 per cent of GDP, and likely to amount to 7 per cent of GDP in 1982/83.

The high inflation rate in New Zealand could perhaps be traced to four causes, Mr. Jaafar considered. First, the stance of fiscal monetary policy had been deliberately expansionary as a means of maintaining full employment. Thus, the markets for both products and labor had been kept under strong competitive pressure, and powerful workers' organizations had succeeded in raising wage rates rapidly. Second, the New Zealand economy was so heavily protected that most domestic industries had virtually no competition from abroad. The level of effective protection had increased further between 1979 and 1982 by the fall in the effective exchange rate of the New Zealand dollar by over 20 per cent. Third, New Zealand had a relatively high import-to-GDP ratio. The country was also heavily dependent on imported oil for its energy requirements, so that increases in import prices combined with the depreciation in the New Zealand dollar had had strong inflationary consequences. Fourth, the high level of indirect taxation on a number of items had certainly raised the price level. Taken together, the four factors had produced inflation rates far in excess of those in New Zealand's trading partners.

He welcomed therefore the far-reaching measures introduced by the authorities to bring inflation under control, Mr. Jaafar stated. The wage price freeze of the kind introduced in New Zealand had advantages as well as disadvantages. For instance, it did not carry with it the social costs in terms of high unemployment that were generally associated with traditional demand management policies. It might, moreover, help to reduce inflationary expectations. On the other hand, wage price freezes often led to distortions of resource allocation; they were therefore not to be preferred over the traditional instruments used for controlling inflation. Moreover, a freeze might provide only temporary relief, if workers and businesses made an attempt to "catch up" soon after the freeze was lifted. The authorities did seem to have considered a number of options before deciding on the wage price freeze. The option of pursuing tight financial policies with the consequent increase in unemployment had clearly been ruled out by the authorities. What they seemed to be hoping was that the freeze would bring down the rate of inflation substantially and set the stage for lower wage increases and slower price rises in future. He could only hope that the expectation would be borne out. He also hoped that the authorities would complement the wage price freeze by measures that would strengthen competition in the economy, in particular by lowering the level of protection.

The size of the fiscal deficit was also a matter for concern, Mr. Jaafar considered. The fiscal deficit was expected to reach 6.25 per cent of GDP in 1982/83 and to rise to 8.5 per cent of GDP in 1983/84.

The fiscal problem had been compounded by the wage indexation system and by the authorities' policy of maintaining public sector emoluments on a par with those prevailing in the private sector. The staff was quite right to suggest that new revenue measures should be introduced to reduce the level of the fiscal deficit. Unfortunately, the scope for new revenue measures was somewhat limited, so that the key to restoring a sound fiscal position lay in expenditure control.

During the present recession, the fiscal situation of many industrial countries had worsened, Mr. Jaafar noted. It was therefore unsurprising that a similar development had taken place in an export-oriented primary producing country like New Zealand. Moreover, in recessionary conditions, the fiscal position of a welfare state was bound to come under increasing pressure because of rising unemployment. It was to be hoped that the situation would improve in 1983/84, when economic recovery might begin to take hold in industrial countries. Meanwhile, he urged the New Zealand authorities to contain the growth of government expenditure and to introduce new revenue measures that would not adversely affect private sector incentives.

In connection with monetary policy, Mr. Jaafar went on, he shared the staff's concern about the freeze on interest rates at a level that meant that most categories of lending and deposits were negative in real terms, thus discouraging financial savings, which were in short supply. Negative real interest rates might lead to the unproductive use of capital, and the promotion of the domestic financial savings through the provision of positive real rates of interest was vital to strengthening of the external sector. He therefore urged the authorities to review their policies as soon as practicable, and to allow interest rates to be determined by market forces.

In the external sector, Mr. Jaafar observed, the current account of the balance of payments was expected to show a deficit of 7 per cent of GDP in 1982/83. The staff attributed that deficit to stagnant world demand, limited access to export markets, and the decline in the terms of trade. Indeed, such factors affected not only New Zealand but nearly every less developed country as well. During the past few years, the differential in the rate of cost increases between New Zealand and its trading partners had been corrected by means of exchange rate depreciations, thus maintaining New Zealand's competitiveness. However, there might well be a significant deterioration in New Zealand's export competitiveness during the current exchange rate freeze. First, as long as the authorities remained committed to maintaining full employment, the inflation rate in New Zealand was likely to continue to be higher than in its major trading partners. Second, the terms of trade were likely to move adversely against New Zealand for some time to come, and the authorities might well have to introduce policies to maintain the profitability of the export sector. In those circumstances, freezing the exchange rate might not be an entirely appropriate policy. His own view was that the authorities should maintain exchange rate flexibility at all times as a means of responding to the changing external environment.

The system of tendering for allocations of licenses, initiated in 1980, had been extended to cover a wider range of goods, Mr. Jaafar noted. Such a practice was disturbing, as it constituted a form of nontariff barrier to trade. Did the staff consider the allocation of licenses to be a form of multiple currency practice? He invited the staff to report to Executive Directors on the progress made in carrying out the Government's intention to reduce the barriers to imports, at the next Article IV consultation.

Finally, Mr. Jaafar remarked that, although New Zealand's external debt was not excessive at present, the recent rate of increase might be unsustainable in the future. All primary producing countries should be cautious in conducting external borrowing, especially from the commercial markets.

Mr. Grosche stated he was in broad agreement with the staff's appraisal. Since mid-1982 a cornerstone of the Government's strategy being the imposition of a comprehensive freeze on prices and wages, as well as on interest rates and the effective exchange rate. Many other countries had found that the experience of relying on a price and wage freeze had not been at all encouraging, and he was not convinced that the policy adopted by the New Zealand authorities would work out successfully. While it was true that, under the influence of the freeze, the real price increases had begun to decline, it could be argued that the improvement had been superficial rather than a reflection of the underlying trend. The authorities could hardly avoid adopting a tight demand management policy as a way of avoiding rapid inflation after the end of the freeze. He was glad that they shared that view and accepted the need for fiscal action. Corrective measures proposed by the staff on page 14 of SM/83/19 were well taken. However, it was his impression that the Government was reluctant to take severe fiscal measures at the present time. It had difficulty in implementing significant spending cuts and felt that its room for maneuver in connection with increasing taxation was constrained. The only measure that the Government regarded as achievable seemed to be an increase in income taxes, something that might be more acceptable to the unions. He wondered whether negotiations between the authorities and the unions had already been held; the staff did not seem to think that any satisfactory outcome was at all likely.

If they were to succeed, the New Zealand authorities would have to combine appropriate financial policies with prudent incomes policies, Mr. Grosche said. While the freeze would result in a decline in real incomes in 1982/83, he was worried that attempts would be made to achieve a catch-up in wages after the end of the freeze. The authorities' intention to begin talks shortly with the trade unions on the postfreeze wage determination system was welcome. He hoped that the outcome of the negotiations would make more allowance for changes in productivity and in the terms of trade.

He was glad that the authorities and the staff seemed to be agreed on the need for external adjustment, Mr. Grosche went on. The current account deficit of 7 per cent of GDP expected for 1982/83 was too large to be sustainable. It had of course to be admitted that external factors, like stagnant world demand and protectionist measures abroad, had played an important part in creating the difficulties facing the New Zealand economy. Nevertheless, he agreed with the staff that a speedy removal of the system of import restrictions would raise the efficiency of the economy and improve the effectiveness of macroeconomic policy; but he admitted that protectionist measures abroad would not make the task easier. The agreement on closer economic relations with Australia might provide an opportunity for accelerating the process, to the benefit of both countries.

Commenting on New Zealand's exchange rate policy, Mr. Grosche remarked that there was a risk that, despite the wage and price freeze, the existing gap in competitiveness between New Zealand and its main trading partners would not be reduced at all significantly. He urged the authorities to keep a close eye on the relative cost position of the country, and to take into consideration the possibility of an early return to a relatively flexible exchange rate policy.

For the medium term, there was, first, an urgent need to overhaul the tax system, and to introduce a value-added tax or broad-based sales tax, Mr. Grosche observed. Second, the authorities clearly needed to complete the major energy-based projects that were expected to contribute significantly to the restructuring of the economy. However, before they began to contribute to the balance of payments, most of those projects would cause a drain on both external and domestic resources. The authorities should therefore pursue their fiscal policy with care, so as to avoid increasing either inflation or external indebtedness unduly. He had been glad to hear from Mr. Morrell that the projects would begin to generate some exchange earnings from 1982/83, a date earlier than the one mentioned by the staff.

Mr. Polak remarked that, in discussing New Zealand, Executive Directors should accept it as a small tightly knit community far away from, yet heavily exposed to, an inhospitable world economy that applied unconscionable restrictions on the country's exports. In those circumstances, it was readily understandable that New Zealand displayed a greater tolerance than many other countries toward control, and perhaps a greater willingness to acccept some of the costs of control in terms of less rapid growth, as a means of ensuring less exposure to the outside world. He would certainly not try to pursuade the New Zealand authorities to change their way of life.

The staff had however clearly shown that New Zealand had become mired in an interlocking set of controls that seemed likely seriously to hurt the future course of the economy, Mr. Polak went on. All the skills of the country's highly competent authorities and officials would be required to extricate the country from its present situation.

Commenting on the freeze on interest rates, Mr. Polak observed that he understood that in a populous and egalitarian society, an interest rate freeze was almost inevitable if a wage/price freeze was to succeed.

Nevertheless, the staff was correct in saying that the approach had been particularly unfortunate at the present time. The interest rate freeze imposed a severe limitation on monetary policy and made it difficult to place with the public at large rather than with financial institutions the volume of public debt needed to finance the large fiscal deficit. When the wage freeze ended, it would be essential for the authorities to revert to the type of monetary policy that they had been following not many years previously.

The situation with the exchange rate was similar, Mr. Polak went on. While the freeze was perhaps inevitable when controls had been imposed on so many other prices in the country, it was also evident that a country that had had an inflation differential of something like 5 per cent for each of the past eight years, and perhaps 10 per cent in the present year, could not maintain a fixed rate against a basket of currencies. As soon as the freeze was over, therefore, New Zealand should revert to a crawling peg, which would enable it to maintain a reasonable level of competitiveness for a number of years. The exchange rate freeze seemed almost certain to have led to what might be called a backlog of overvaluation, which would require some measure of immediate adjustment. It might even be necessary to face the question whether a country so heavily reliant on export subsidies and import restrictions had had a rate that was properly competitive even before the freeze had been imposed. Some additional depreciation might therefore be required after the freeze if the economy was to become properly competitive.

He had been glad to hear Mr. Morrell say that the authorities had been actively pursuing policies aimed at freeing the economy from protection, Mr. Polak stated. The staff had not given the same impression, and the limited auctioning of import licenses did not seem to be a great step along the way. He hoped that the New Zealand authorities would enter the waters of international competition, perhaps in connection with the arrangement with Australia, because he saw competition as an essential ingredient for lifting New Zealand out of its present extreme economic nationalism, and out of all the high costs thereby entailed.

Mr. Teijeiro considered that the present consultation with New Zealand was timely. Although the economic situation had deteriorated during the past few years, the present difficulties had not yet become so great that they could be reversed only at the cost of major losses in output and employment, provided that appropriate measures were taken soon. At the present stage of economic developments in New Zealand, the Executive Board discussion ought to be comprehensive enough to provide the staff and the authorities with useful insights into possible solutions for current problems.

New Zealand was facing a serious need for external adjustment to external difficulties such as shrinking export markets and deterioration in the terms of trade, Mr. Teijeiro continued. While protectionism and economic instability throughout the world were the cause of New Zealand's economic difficulties, he shared the staff view that a further liberalization of trade would make a major contribution to the structural adjustment of the economy. He did of course realize that such liberalization could be politically difficult when all the evidence seemed to show that the major industrial countries intended to maintain and even increase their protectionist practices. New Zealand's traditional exports were greatly affected by the restrictions imposed in its export markets, as could be seen by the table on page 94 of SM/83/22. In the circumstances described on that page, it was difficult to see how New Zealand's political leaders could obtain any consensus for reducing protection. The major industrial countries would clearly have to take the intiative in trade liberalization if the world was to make any significant progress during the next decade.

Despite the present difficulties, the New Zealand authorities were making efforts to rationalize their trade restrictions, Mr. Tejeiro remarked. Several studies on effective protection were in an advanced state of completion, and some phases of the program for reductions of restrictions were already in place. For all that work, the authorities were to be highly commended. The elimination of quantitive restrictions should be given the highest priority, and a comprehensive view of the tariff system ought to be undertaken for the purposes of reducing the dispersion of tariffs as fast as possible in the transition period. Tariff dispersion produced a potential dispersion of effective protection, leading to a high degree of inefficiency in the industrial sector. The factors of production were very mobile in the industrial sector; consequently, small dispersions of effective protection could produce high degrees of inefficiency.

As any relaxation of protection in the industrial countries seemed unlikely in the near future, Mr. Teijeiro stated, the crucial issue for the New Zealand authorities was to find an appropriate policy for exporting manufactured goods. Manufacturing represented some 23 per cent of GDP, but 90 per cent of total production was sold domestically, and only 10 per cent was exported, despite the small size of the domestic market. All the evidence suggested that manufactures ought to play a much larger role in exports. The reason why the situation was unsatisfactory in New Zealand was clearly the presence of a strong anti-export bias in the present incentives for manufacturing. The most important distortion appeared to lie in the difference between the incentives for manufacturing for the domestic market and those for manufacturing for export. The present incentives for manufacturing for exports did not make up for more than a small proportion of the distortion. Unfortunately, adherence to GATT rules was likely to force New Zealand to reduce its use of export incentives considerably. He wondered whether such a change would improve the efficiency in the allocation of economic resources.

It might after all be considered that export incentives for manufacturers were a way of generalizing protection for the manufacturing sector as opposed to the agricultural sector, Mr. Teijeiro considered. Such an arrangement might be appropriate in two specific instances. First, a lack of protection for agricultural production might be considered desirable if the agricultural producers had a monopoly in traditional export markets. He was not sure that there was a significant case of monopoly power in New Zealand's traditional exports; however, the heavy reliance on quantitative import restrictions by industrial countries suggested that fluctuations in New Zealand's exports could affect its terms of trade significantly. Even if export promotion could not be considered the most desirable policy, there were perhaps arguments for considering it a second-best. For instance, it might be assumed that political considerations prevented any significant reduction in import restrictions. In those circumstances, raising the export incentive for manufacturers would reduce the anti-export bias and the distortions inside the manufacturing sector, thus improving economic efficiency. At the same time, however, protection for manufacturing would on average be increased as opposed to the lack of protection for agriculture, thus implying a negative impact on economic efficiency. It ought to be possible to devise combinations of reductions in import protection and increases in export promotion that would leave the protection for manufacturing unchanged on average. The net gain of such a combination would arise from distortions in the industrial sector leading to the contraction of domestic-oriented industries and the expansion of export oriented ones.

In the circumstances that he had described, Mr. Teijeiro said, he felt particularly uncomfortable encouraging partial measures toward free trade without giving proper consideration to the whole set of domestic and external distortions that might exist in any given country. Trade policies should be an important part of programs under an extended Fund facility. He wondered whether the Executive Board had had an opportunity to discuss that point in detail.

As for New Zealand's current economic situation, he shared the view that a major adjustment would be necessary, Mr. Teijeiro stated. Part of the present current account deficit would probably disappear with an improvement in the terms of trade. However, it was large enough to suggest that important part of it was noncyclical. Adjustment of the exchange rate, with a consequent adverse effect on domestic real wages, seemed unavoidable if the deficit was to be significantly reduced. The main issue was how to make the required adjustment without promoting a wage/price spiral.

Two elements made it difficult to apply a useful wage policy in New Zealand, Mr. Teijeiro observed. High industrial protection implied that large segments of the economy were not exposed to foreign competition. Industry was therefore in a position to pass on wage increases to domestic prices too easily. Furthermore, the instability in the terms of trade might in fact lead to an upward trend in real wages in view of the downward rigidity of wages at times of declining terms of trade. If a new upsurge of inflation was to be avoided, attempts should be made to reach a new consensus on wage policy. In most countries, it was not politically feasible to bring about a moderation of wage adjustments at the time of expansionary fiscal monetary policies. In other words, tight fiscal monetary policies were a crucial element in the building up of a consensus, which would be essential to prevent the necessary adjustments in the external sector leading to increased inflation. He would welcome any comments from the staff or Mr. Morrell on the likelihood of the need for adjustment in the external sector being used to bring about changes in relative prices within the tradable goods sector as a means of reducing the present degree of distortion in the allocation of economic resources in New Zealand.

Mr. Hirao commented that New Zealand's economy had expanded strongly in 1981/82, with domestic demand increasing by over 6 per cent. However, the staff had noted that expansion had been out of step with the external environment and had therefore become unsustainable, mainly because of the difficulties with external balances. The current account deficit had risen, and inflation had persisted at about 15 per cent or higher. During 1982/83, economic activity had slowed markedly. The difficulties in 1982/83 had been compounded by the rise in the current account deficit and the increase in unemployment. The authorities had reacted by attempting to arrive at the consensus with the social partners in the form of a wage/tax trade-off. As those efforts had proved unsuccessful, the freeze on price and wages had been imposed for one year, together with ceilings on interest rates, in an effort to break inflationary expectations.

The staff had shown that the country's economic difficulties could be traced to the sharp expansionary shift in the direction of financial policy in 1981/82, Mr. Hirao considered. The budget deficit had amounted to 6.3 per cent of GDP in that year. The expansionary impact of the fiscal policy seemed to be persisting not only in the present year but in future years. In more general terms, the staff had noted that over the decade 1971/72 to 1981/82 the ratio of government expenditure to GDP had risen from 28 per cent to about 40 per cent. In real terms, the growth had averaged some 5 per cent per year, while revenue had risen only 3.5 per cent per year. A second notable aspect was the high rate of growth in public investment. Table 1 on page 16 of SM/83/19 showed that gross public fixed investment had increased in real terms by 12.4 per cent in 1981/82 and 13.6 per cent in 1982/83; it was forecast to rise by 15.0 per cent in 1983/84. In those years GDP had changed, or was expected to change, by 4.4 per cent, -1.9 per cent, and -0.3 per cent, respectively. The authorities seemed to agree that active fiscal stimulus was justified in a sharp cyclical downturn, although they recognized the need for adjustment in the area of government expenditure and taxation. He was encouraged by having heard Mr. Morrell say that, in addition to the reform of the tax system, a major medium-term objective in public finance was to bring about a slowdown in the growth of public expenditure, based on the reassessment of spending objectives and the application of principles consistent with the overall efficiency of the economy.

The staff had indicated that interest rate controls were viewed by the authorities as an integral part of the wage/price freeze, Mr. Hirao noted. Unfortunately, the controls seemed to have constrained any active use of monetary policy, since interest rates were being held down when the need for ensuring noninflationary financing of the budget deficit was rather high. It was certainly encouraging to note that, under the influence of the freeze and of the slowdown in activity, the rate of inflation had slowed in recent months. Nevertheless, the authorities ought to continue with a tight financial policy in order the prevent the re-emergence of inflationary pressures after the end of the freeze.

The freeze was having the desired effect of holding down prices and wages, Mr. Hirao observed; and the authorities seemed determined not to allow any significant breakout of inflation following the end of the freeze. He hoped that the tripartite discussions would reach a consensus on the methods of postfreeze wage determination. At the least, wage and price freezes entailed considerable costs in terms of the distortion of markets and the misallocations of resources. He hoped that the authorities' efforts to contain inflation would in the end take the form of the application of appropriate fiscal and monetary instruments.

Externally, New Zealand seemed to face a significant problem of adjustment, Mr. Hirao stated. The current account deficit was expected to increase further to 7 per cent of GDP in 1982/83. The adoption of an appropriate domestic macroeconomic policy would of course be essential to support the required external adjustment. The early resumption of a more flexible exchange rate system seemed desirable as a means of preserving the competitive position of New Zealand. The authorities should certainly continue to watch the evolution of foreign debt most carefully, even though the country still enjoyed high credit ratings in international financial markets. However, he noted with great interest New Zealand's agreement on closer economic relations with Australia. He hoped that it would provide an opportunity for a further reduction of protection and continue to improve the competitive climate in the economy.

Mr. Tvedt considered the situation in New Zealand to be interesting. New Zealand was an advanced, high-income country characterized by substantial structural rigidities. His chair had long been a strong proponent of comprehensive and effective incomes policies. He therefore had great sympathy with the efforts of the New Zealand authorities in trying to achieve a consensus on incomes policy. He was however disappointed by the authorities' failure to reach a broad-based consensus. The establishment of domestic rigidities in the recent past almost called out for the creation of a social contract as the only path to salvation. Fiscal policy seemed inflexible and unlikely to contribute to any structural adjustment in the near future. Moreover, monetary policy had been stripped of its most potent instrument. The staff had clearly described the severe rigidities in the wage structure, and the present external current account deficit was unsustainable.

It was difficult to argue with the Government's criteria in selecting a comprehensive wage/price freeze as its main line of policy, Mr. Tvedt commented, given the serious effects of restrictive financial policies in many other countries. The authorities were bound to try to break inflationary expectations, and the freeze had apparently been well received by the public. However, a freeze alone would not solve the problems confronting the authorities, and it was important they should do their best to bring about a comprehensive incomes policy for application in the post-freeze period. If not they would have gained nothing in the interval. The public would have to become fully aware of the nature of the structural problems and be pursuaded to participate in the process of overcoming them. An incomes policy would of course have to be accompanied by firm fiscal and monetary policies. He would be interested to hear if there was any information on intended postfreeze policies, and perhaps on the prospects for a modification of the way in which wages were determined.

It was unfortunate that interest rates were covered by the freeze, Mr. Tvedt commented. In the present circumstances, they could have played a useful role in generating domestic financial savings, and they could have contributed to an improvement in the external account. The debt situation should be monitored carefully, especially as recovery in New Zealand was likely to take place some time after recovery in other parts of the world economy.

As to the trade restrictions imposed by New Zealand, Mr. Tvedt commented that the effects of similar restrictions in other countries on New Zealand's exports should make their ultimate impact only too abundantly clear. Furthermore, continued adherence to the present arrangements would only hamper the growth of the economy. It seemed evident, therefore, that the authorities should continue to work for liberalization; the recent agreement on closer economic relations with Australia might be an important milestone in that connection.

Mr. Suraisry said that he could generally endorse the well-balanced staff appraisal. It was clear that the New Zealand economy was going through a difficult period: real growth was flat, unemployment was rising, and inflation was in double figures. Both the fiscal and external deficits had risen to historically high levels as a proportion of GDP. The immediate prospect was not encouraging, and the medium-term outlook was clouded by a number of structural weaknesses.

In the circumstances, Mr. Suraisry remarked, the shift to expansionary policies in late 1980 had resulted in only short-lived gains, and the swing back to more restrictive polices in 1982 had involved other costs and distortions. He was glad to know from Mr. Morrell that the freeze had shown some signs of success in enabling the Government to attain its main objectives. However, despite the authorities' determination not to allow inflation to break out after the end of the freeze, he shared Mr. Taylor's fear that wages could well increase substantially in the latter part of 1983, thus complicating the authorities' efforts to overcome inflation. He therefore agreed with the staff that the authorities needed a more durable incomes policy; he hoped that progress could be made in the talks now under way between the Government and the trade unions with a view to linking wage awards more closely to productivity.

Whatever the outcome of the talks, Mr. Suraisry went on, he shared the staff view that an incomes policy by itself would be insufficient to deal with the present imbalances in the economy. Firm financial policies were also required. Priority should be given to the New Zealand budget deficit. The combination of expenditure accounts and tax changes suggested by the staff seemed appropriate. The introduction of a sales tax would broaden the revenue base and strengthen the Government's financial position in both the short and the medium term.

On the monetary side, it was clear that controls on interest rates could not be removed unless the wage/price freeze had come to an end, Mr. Suraisry remarked. He hoped that the authorities would soon be in a position to resume progress toward opening up the financial system and operating their monetary policy in a more flexible manner.

On the external side, Mr. Suraisry observed, there was clearly a need to improve New Zealand's competitiveness. The sizable current account deficit could not be sustained without further compensatory borrowing, which would increase the costs of adjustment. A more flexible stance on exchange rates could be one element in the authorities' strategy, provided that it was supported by firm domestic policies. He would be interested to know whether the authorities intended to resume a policy of gradual exchange rate adjustments in the near future.

Finally, Mr. Suraisry recalled, the staff had made a strong case for early action to liberalize the trade system. Any such program would of course take time, and it would not be easy to introduce, particularly when New Zealand's major exports were facing barriers in other countries. Table 43 of SM/83/22 showed how comprehensive those barriers were, and how difficult were the problems confronting New Zealand's exports. Nevertheless, he urged the authorities to move as quickly as they could toward the liberalization of trade, and the recently negotiated trade agreement with Australia was an encouraging sign. While the problems were serious, the New Zealand authorities had shown their ability to deal with such difficulties in the past. He was sure they would be able to do so again.

Mr. Erb stated that he could support most of the conclusions reached by the staff. The situation in New Zealand was worrying; significant adjustments would have to be made, especially in the structure of prices in the broader sense, covering not only domestic goods but also imports, interest rates, and the exchange rate. All the prices had been too rigid to permit the adjustment that was needed. While the problems confronting New Zealand were not unlike those facing a number of other countries, they were in many ways long term in nature. The staff had in fact said that since the mid-1970s New Zealand had been suffering from low economic growth and high and rising unemployment, as well as high rates of inflation and large external current account deficits. The Government's policy response seemed however to have been essentially short term in nature, consisting mainly of stimulating demand and applying a variety of direct controls and allocating resources. His authorities doubted the efficacy of wage and price controls even in circumstances where they were strongly supported by appropriate monetary and fiscal policies. Unfortunately, such conditions had not existed in New Zealand, and the underlying fiscal and monetary policies had not worked in the same direction as the controls. It therefore seemed likely that the wage and price controls would simply suppress price increases without breaking inflationary expectations. There was therefore a danger of a surge of inflation in the near future. He was also concerned about the distortions brought about by the price rigidities and the interest rate freeze.

Commenting on certain aspects of the wage situation, Mr Erb noted that the effect of extreme rigidity on relative wages was nearly always harmful. Moreover, real wage rates had been rising over time and had reached a point where they were squeezing private sector profits. It would therefore be of interest to hear from the staff what impact the squeezing of private sector profits had had on investment and on the rate of real economic growth in New Zealand.

He had noted in SM/83/19 that the ratio of government expenditure to GDP had risen sharply over the past decade until it now stood at some 40 per cent of GDP, largely as a result of consumption-oriented growth, Mr. Erb remarked. In addition, the fiscal deficit had risen and was expected to continue rising to a relatively high level. Consequently, expenditure restraints should be given high priority. Meanwhile, it would be interesting if the staff could comment on the impact on investment of the high proportion of government expenditure and the high budget deficit, and then on the longer-term growth prospects for output and employment. Both a high proportion of government expenditure and the high budget deficit were said to lead to the crowding out of private investment, and he had therefore been particularly interested in Mr. Morrell's statement that the Government intended to compete aggressively for funds from the private sector in order to finance the deficits in the least inflationary way possible. While the approach was certainly correct, the impact on potential investment was likely to be strongly negative. He had been impressed by the recent reductions in high marginal tax rates. It was unfortuate that offsetting revenue raising measures had not been introduced in light of the large fiscal deficit.

It was evident that substantial adjustment would be required in the external sector as well, Mr. Erb went on. The large current account deficit and the growth in external debt were both worrying. It seemed unlikely that the economy would be able to sustain over time the rise in the proportion of external debt to GDP without adverse effects on private investment. External borrowing seemed to be used to maintain a higher standard of consumption than would otherwise be the case, rather than being channeled into productive investment.

He agreed with other speakers, Mr. Erb remarked, that New Zealand's trade regime was most inefficient. He hoped that the authorities would rely more on the exchange rate, and if need be tariffs, than on quantitative restrictions as a means of bringing about adjustment. If quantitative restrictions could not be dismantled at present, he would support the expansion of the system of offering import lisenses for sale; such an arrangement was more efficient than an import license system that was not open to any competition.

He understood that New Zealand was suffering seriously from trade restrictions imposed by other countries, Mr. Erb stated; but New Zealand's own restrictive system did seem to impose high costs on the citizens. It might be in New Zealand's interest to relax its restrictive system even if its trading partners could not be pursuaded to do so at the same time.

Mr. Casey remarked that the freeze imposed by the New Zealand Government on wages, prices, interest rates, and the exchange rate seemed like last-resort measures that would only compound the existing distortions and do little to reduce the underlying rate of inflation. He sympathized with the authorities not only because the difficulties had been brought on largely by forces outside their control, but also because they were clearly confronted by powerful lobbying groups at home. New Zealand had once had one of the highest incomes per capita in the world; it had lost that position largely, he believed, because of the extent to which it had protected its own industries. While he could understand the frustrations of wage earners, the authorities ought to be firmer in explaining the facts of economic life. The economy could not afford the high wages that were squeezing profits and causing unemployment. Nor could it afford the mounting government expenditure on social welfare, and it could certainly not afford income tax concessions which had in the past not even led to the lessening of wage demands.

The recent increases in indirect taxation had done little to offset the losses in income tax revenue sustained by the authorities as the result of concessions in connection with the freeze, Mr. Casey observed. The reluctance of the authorities to adopt a value-added tax or broad-based sales tax had led to a position in which the public sector borrowing requirement could reach 8.5 per cent of GDP in 1983/84, while the debt service ratio would rise to a very high level for an economy at New Zealand's stage of development. The balance of payments was also under pressure, and compensatory borrowing would increase.

He had noted that one of the reasons for the income tax concession was that the high marginal tax rates had led to evasion and avoidance, Mr. Casey noted. It seemed extraordinary that the authorities would seek to reduce evasion and avoidance by lowering taxes rather than by improving collection procedures. In any event, it was disquieting to note the laxity of fiscal policy and the undercutting of monetary policy both by the rising public sector borrowing requirement and by the freeze on interest rates.

Like Mr. Taylor, Mr. Casey went on, he wondered whether the freeze on interest rates was not redundant. He could understand that the authorities were trying to accommodate a number of sectional interests, but, while individual groups might gain in the short term, the economy as a whole would suffer, and no one would benefit. He wondered if the development of natural energy resources would come to the rescue both of the public finances and of the balance of payments at some time in the future. Perhaps that expectation was a partial explanation of the present lack of substantive macroeconomic policy.

After the end of the freeze the authorities appeared to be considering adopting a fairly flexible exchange rate policy, Mr. Casey observed. Like Mr. Polak, he doubted whether a crawling-peg arrangement would be adequate. Competitiveness would still be a problem, probably more serious after the end of the freeze than previously. One way of tackling all those problems would of course be to tighten severely both fiscal and monetary policy, thus preventing excessive wage increases while admittedly leading to higher unemployment. Another approach would be to adopt a somewhat less tight stance of demand management while accepting a fairly marked devaluation. The inflationary consequences might not be very pronounced, first because the tradable sector was not very large as a proportion of GDP, second because a discrete devaluation might provide an important lesson for the trade unions, and, third because wage earners seemed to be more concerned about pay differentials than about the cost of living. Wage indexation should be abolished in any event, especially as the form practiced in New Zealand made no allowance for terms of trade losses. If such a policy package, including a devaluation of the currency, was to be effective, greater efforts would have to be made to reduce trade protection, which was perhaps in any case a second-best substitute for devaluation. He hoped that the agreeement on closer economic relations with Australia could prove to be an appropriate answer to the European Community.

Mr. Caranicas commented, in connection with trade protection, that the difficulties of New Zealand on the external front had been ascribed, first, to the relative stagnation of agricultural output, second, to widespread problems of access to foreign markets, and, third, to the sharp deterioration in the terms of trade. However, with regard to the latter, Chart 3 in SM/83/19 showed that, while the terms of trade had deteriorated in the early 1970s, since 1976 they had been improving rather than the reverse.

One of the particularly harmful features of the protective system applied in New Zealand, Mr. Caranicas observed, was that it made wide use of import quotas and an escalating tariff structure. He supported the staff's view that the protective system had played a large part in raising the domestic cost structure and in creating a strong bias against the export sector, thus compelling would-be exporters to call for special support. He understood that the New Zealand authorities had difficulty in reaching a consensus on the ways of tackling the difficulties, particularly in the face of rising domestic unemployment and the worldwide climate of protection. Nevertheless, like the staff, he considered that a relatively speedy removal of the protection system would make a major contribution to the structural adjustment of the New Zealand economy. Indeed, it could be argued that the reduction of protection was fundamental to raising the efficiency of the economy and enhancing the effectiveness of other instruments of macroeconomic policy. Protection was in his view one of the main obstacles to progress by the New Zealand economy.

He had been interested in Mr. Morrell's observations that his authorities continued to be concerned by the damaging effect that protectionism was having on the access to markets not only of New Zealand's primary produce but also of that of other primary-produce exporters, Mr. Caranicas stated. He had also heard expressions of hope that the recent agreement with Australia under which New Zealand manufacturers would have preferential access for a range of products would bring benefits to both countries. However, Australia was also a large-scale producer of primary products similar to New Zealand's agricultural and pastoral exports, and it was precisely in that area of trade that the most restrictive nontariff barriers were found. Even so, the agreement with Australia would help New Zealand in a limited way. In the meantime, the authorities would have to take more forceful action for accelerating the country's program of structural adjustment.

Mr. Erb remarked that while he had argued that excessive rigidity in the New Zealand exchange rate was undesirable, he could not agree with Mr. Casey that a major devaluation would help bring about adjustment for New Zealand. Unless a devaluation were accompanied by appropriate domestic policies, some liberalization of imports and the reduction of export subsidies, the outcome seemed likely to be similar to the outcome in Sweden, where devaluation had taken place, initially in the absence of complementary adjustments.

Mr. Jayawardena complimented the staff for having bravely tackled trade matters in its report. His authorities saw New Zealand's policies as an extremely cautious and painful attempt to adjust to a difficult external environment. In face of the serious decline in the terms of trade and the extraordinary protective policies introduced in New Zealand's traditional export markets, they wondered whether concepts such as appropriately flexible exchange rate policies and the liberalization of the domestic economy were anything more than hollow shibboleths. It was difficult to see how a more flexible exchange rate policy would help New Zealand to increase its exports, which were being systematically discriminated against in the markets of the more developed countries. The appendices in SM/83/22 made very painful reading. The Executive Board should be careful not to preach the adoption of policies that would be impossible to implement because of the behavior of other members.

In that connection, Mr. Jayawardena mentioned, he welcomed the recent decision by the Fund to examine trade policies and issues in more detail as part of the consultation process. He had noted from pages 91 and 92 of SM/83/22, which displayed the trade restrictions on New Zealand's exports, that the impact of trade restrictions and of overall protection were already being studied elsewhere. In view of the seriousness of the problem, however, he wondered whether the Fund ought not to try to catalog the various restrictive measures and their impact on the economies of different member countries, for a general discussion by the Executive Board at a later date. He had in mind something more detailed than the papers on trade polices so far presented to the Executive Board. He hoped that one day the Fund would take the lead in the matter and graduate from platitudes to more meaningful action. Many distorting domestic policies in countries throughout the world were forced upon the authorities by hostile external circumstances, and sentiments for trade protection did not seem to be abating.

The Acting Chairman stated that he had noted Mr. Jayawardena's request for a more active attention to trade matters by the Fund. In practice, the staff was paying considerably more attention to trade matters than in the past. There was however a limit to the extent to which the Fund could enter into that field, not only because of restrictions of manpower, but also because of the agreement to intensify collaboration with the GATT Secretariat on such matters.

Mr. Casey explained, in reply to Mr. Erb, that he had not been advocating competitive depreciation. Nevertheless, when the wage/price freeze ended in New Zealand, it did seem likely that there would be a sudden rebound in wages, with a relatively bad effect on the country's competitive position. In those circumstances, the exchange rate might well be overvalued, and a relatively large discrete devaluation might be needed. Naturally, any devaluation would have to be accompanied by the appropriate domestic macroeconomic policies.

Mr. Caranicas commented that it seemed to him that trade matters were the province of other agencies such as the General Agreements on Tariff and Trade (GATT) and the United Nations Conference on Trade and Development (UNCTAD). Meanwhile, the Fund staff was so thinly spread that he would not wish to see it undertake further activity in the trade field, which could be handled by other agencies. The Fund should restrict itself to its surveillance and balance of payments functions.

The Acting Chairman remarked that he completely agreed with Mr. Caranicas that the Fund should not trespass in the GATT realm; however, the danger of protectionism was so great that the Fund ought not to spare any effort to roll back the protectionist tendencies afflicting the world.

The Deputy Director of the European Department responded first to the suggestion that the staff had perhaps understated the seriousness of the problems facing New Zealand. The staff believed that it had pointed to all the main areas in which it had thought that corrective action was needed. He would agree with speakers that unless corrective action were taken in many of those areas fairly shortly, the situation could become serious indeed.

As to the longer-run effects of the growth in real wages in New Zealand, the Deputy Director reminded Executive Directors that private investment had been stagnant for some years. While it was not possible to prove that the growth in real wages had been the whole, or even the main, factor in causing stagnation, instinct suggested that it was important, though there was some evidence to suggest that the rate of growth of real wages had promoted labor-saving investment. On the question of the effect of government deficits on investment, he, like Mr. Erb, had been glad to hear Mr. Morrell say that the Government intended to compete aggressively for funds from the private sector. In the past few years, the Government's attitude could hardly be described as being aggressively competitive for funds. Consequently, the dangers of a large government deficit putting pressure on interest rates had not materialized so far. If in fact the Government did compete aggressively, he might be slightly alarmed at the possible impact on interest rates; but he started from the premise that the government deficit could not be allowed to continue at anything like the present level.

Commenting on questions raised by Executive Directors regarding wage problems, the Deputy Director remarked that the staff had not been proposing any particular form of social contract for New Zealand. What the staff did hope was that some of the rigidities at least would be tackled shortly, for the purpose of gradually freeing the economy from the multiplicity of controls. For instance, one problem in New Zealand, as in many other countries, was the high rate of youth unemployment. In such a situation, any observer was bound to ask whether it was sensible to pay young people in their teens the wage that was paid to fully qualified wage earners of 30 or 35. Similarly, there was an elaborate set of provisions in New Zealand for securing wage parity--or even parity plus--between the public and private sectors. Urgent attention should certainly be given to that situation.

The Prime Minister of New Zealand had recently said that the Government was determined not to repeat the monetary experience of 1981/82, and that he wished to maintain appropriately tight monetary policies, the Deputy Director continued. He had also said that he was sure that in the medium term, interest rates would move down in line with the fall of inflation. The precise way in which those two statements could be reconciled was not immediately evident, but it was clear that the authorities favored tightening their monetary policy.

Taking up remarks in the exchange rate field, the Deputy Director explained that the staff had suggested that as a minimum the authorities ought, after the end of the freeze, to return to the policy of maintaining the real rate of exchange unchanged. The staff had not committed itself on the point of whether the nominal rate should be adjusted somewhat further than necessary in order to bring about some real depreciation. Until it was possible to see what sort of domestic policies would be in place at the end of the wage/price freeze, it was impossible to be more specific about the kind of exchange rate policy that would be required.

In the matter of foreign debt, the Deputy Director recalled, some Executive Directors had suggested that the authorities ought to do more than watch the debt situation. The staff view was that the debt should not be allowed to grow any further except insofar as it was matched by a growth of investment, including the completion of the present major industrial projects, which did involve a good deal of foreign borrowing. Meanwhile, the authorities ought to watch not only the total of their indebtedness but also such matters as its composition and maturity.

There was no implication in the staff remarks that the New Zealand authorities were indifferent to the debt situation; that was far from the case. As to the size of the debt, official debt, which had been $NZ 6.8 billion in March 1982, had risen to $NZ 7.4 billion by September 1982, the equivalent of some 26 per cent of GDP. The figures to which Mr. Taylor had referred had been published in the press during the mission's visit to Wellington. Besides official debt, they had included the debt of public enterprises. The figures, while perhaps fairly accurate, had not been officially sanctioned. The staff had little information on private debt.

The auctioning of import licenses, the Deputy Director explained, did not constitute a multiple currency practice. The tendering was made in local currency, and only a transaction in local currency was involved.

As to the comment that two years had elapsed since the previous Article IV consultation with New Zealand, the Deputy Director of the European Department recalled that the New Zealand authorities had invited a Fund mission to Wellington in March 1982. At that time, the staff had found itself unable to accept the invitation because of a shortage of qualified people. The staff certainly hoped to avoid any such long interval in the future; he would agree that the precedent was not a good one.

The staff representative from the European Department remarked that the New Zealand authorities regarded the issues of lessening import restrictions, export incentives, and action in the exchange rate field as clearly interrelated. In New Zealand, export incentives had traditionally been viewed as a way of compensating the export sector for the cost that it had to bear as a result of the country's protectionist trade regime. Moreover, as in many other Fund member countries, in New Zealand fiscal action in the trade area was viewed as a substitute for action on the exchange rate. Naturally, there was always the danger of creating a vicious circle wherein the lack of action in one field was rationalized by referring to difficulties in others. In that context, it was worth noting that in connection with the Closer Economic Relations Agreement with Australia, New Zealand had undertaken to remove its performance-based export incentives by early 1987, thus bringing to the surface the need for a decision on an appropriate sequence of action in each of the related fields. The New Zealand representatives had indicated that they were somewhat concerned by the implications of having to remove tariffs before quotas under the agreement with Australia. They had however emphasized that their objective would be to dismantle the quota system and to replace it as soon as possible by tariffs.

Mr. Morrell stated that he would pass the many valuable comments to his authorities in New Zealand, who would certainly find them useful. The authorities in Wellington had already gained a great deal from their discussions with the staff.

The authorities were well aware of the cost of protection, and equally of the cost of the absence of protection, Mr. Morrell remarked. They had initiated studies and had acted on the findings of some of them, for one of the characteristics of New Zealand was the desire to try to involve the affected parties in all types of political discussion. The hope was that, when changes were instituted, they would be acceptable to all concerned. The recently concluded agreement on closer economic relations with Australia had involved a quite painful process in New Zealand before agreement had been reached to reduce the protective barriers. The pace at which some of the barriers were being removed had been found rather slow by some parts of Australian industry, but progress was being made. Regarding Mr. Casey's comments, he hoped that the agreement for closer economic relations between Australia and New Zealand would not do for the rest of the world what the European Common Market had done.

There had been some criticism of the poor performance of the New Zealand economy, Mr. Morrell noted. There had been an expansion of real growth in 1981/82 although there had been a decline in 1982/83, and the unemployment rate was still relatively low by international standards despite terms of trade that had worsened by 5.8 per cent in 1979/80, 10 per cent in 1980/81, and 2 per cent in 1981/82. If Mr. Caranicas had found that the terms of trade had improved since 1975, that was because he had started from the lowest possible point. The terms of trade had weakened substantially in the period immediately preceding 1975, so that it was only to be hoped that they would in future be above that level. The position was not at all favorable.

A number of Directors had commented on the lack of success with wage/price freezes in their own countries, Mr. Morrell recalled. The New Zealand authorities were well aware of the difficulties involved, and they were determined to make sure that there was no explosion either of wages or of prices after the end of the freeze. It seemed unlikely that there would be any rapid changes after June 1983. There would certainly be government surveillance over wages and prices for some time to come. As to whether the negotiations with the trade unions would be successful, it was worth noting that, in negotiations in which wages and tax rates were linked, although the unions were agreeing to constraints on their members' wages, the benefit in terms of a reduction in income taxes accrued to all sectors of the community. Basically, then, the union representatives were asking why their members should reduce their income share in order to obtain tax benefits, when other income earners would not reduce theirs. Consequently, in order to obtain a consensus, the authorities had almost been compelled to offer a comprehensive set of controls. The next stage in the adjustment process would have to go beyond negotiating. The authorities would have to convince the wage earners that they would have to yield without getting anything in return. The wage/tax trade-off had been expensive; in view of New Zealand's fiscal problems, it could not be repeated. It was therefore essential that the people should understand that they would have to submit to a reduction in income; the freeze had been a helpful device in focusing people's attention on the situation.

Despite the staff comments, Mr. Morrell maintained that the New Zealand Government had followed aggressive borrowing programs in 1979 and had raised considerable amounts of money from the public even as late as

1981. Nevertheless, public borrowing did not convince the people that the country as a whole was in difficulty. The people generally perceived problems only in such areas as the housing market or rising interest rates. Consequently, while tight monetary and fiscal policies were a classical prescription for fighting inflation, they were not necessarily a means of persuading people in the country to understand what the problem actually was. The wage/price freeze had been well received, and had caused public notice to be taken of the country's difficulties. If the Government had merely announced a large increase in interest rates, it would have affected only the comparatively wealthy, and the mass of the people would not understand that the country was facing a major problem. As well as being useful in causing the people to understand the difficulties, the freeze--even including the imposition of controls on interest rates--had given the Government an opportunity to think out a sound monetary policy.

While it was true that policies had become rather lax in 1981, the situation had been to some extent self-correcting through the balance of payments deficit and the relatively tight fiscal position, Mr. Morrell remarked. There had indeed been a severe tightening of monetary conditions in 1982, and the Government had become determined to compete aggressively for funds to finance the public deficit, to such an extent that there was some danger of crowding out. Large-scale industry, of course, had the option of borrowing overseas; as had happened in the past in New Zealand, if government policies were sufficiently tight, there would be an increase in private borrowing abroad. As the New Zealand authorities had not yet made their plans public, he was not in a position to reveal them to Executive Directors; but they did have plans for redressing the fiscal situation that were ready to put into operation.

The interest rate controls, Mr. Morrell went on, were part of the complete package that had gone into the freeze. Even if they did not have any great impact, their very existence did help to achieve a consensus. New Zealand had spent many years trying to achieve an incomes policy; the present events represented yet another attempt. By showing some of the strength of the Government's hand in imposing the freeze, they might lead to a satisfactory wage determination process.

Executive Directors had made many interesting comments on the exchange rate regime in New Zealand, Mr. Morrell considered. The staff had apparently presumed that a policy of exchange rate adjustment would be resumed after the end of the wage freeze period. No firm decision had in fact been made in that respect. The comments of Directors would be helpful to the authorities in New Zealand and he would certainly make them available, for their use in considering appropriate action.

Commenting on the system of incentives, Mr. Morrell reminded Executive Directors that New Zealand was regarded as an industrialized country with a large proportion of its export earnings coming from agricultural and animal-based products. As a result, if the authorities adjusted the exchange rate to meet the price behavior of the country's major exports, the adjustment would provide disruptive conditions for manufacturing industries. In practice, exchange rate policy had been related to industrial output. The policy had been followed fairly steadily, taking into account cost differentials between industrial production in New Zealand and industrial production overseas. The authorities had therefore offered separate incentives for the producers of livestock as a means of providing stability that could not possibly have been provided simply by exchange rate adjustment. The New Zealand authorities believed that the system of specific incentives that they were using was preferable to the broad-brush methods of exchange rate change.

Responding to a question about the declining profitability of industry raised by Mr. Erb, Mr. Morrell remarked that there had been a marked decline in the amount of tax paid by companies because of the effect of the export incentives. Consequently, the after-tax position of export companies in New Zealand had been much sounder than their before-tax position. While such an arrangement might not be very satisfactory for the public finances, it had maintained profitability in export industry and encouraged industry to export.

As to the fiscal position itself, Mr. Morrell remarked that the major problem had been the growth of government expenditure. Some of the programs had been introduced by the present Government, and it would be politically difficult to abandon them. If government expenditure had to be reduced, there would need to be some fundamental adjustment in certain features of New Zealand life, in particular in social welfare. The authorities had such matters under review, but it was not certain that decisions on which cuts would be made had yet been taken.

Regarding the suggestions for the introduction of sales taxes or value-added taxes, Mr. Morrell indicated that the Government had initiated a study of the tax system; the conclusion had been that the adoption of a more widespread sales tax or a value-added tax would be appropriate, especially as there was a need for a major shift from direct to indirect taxes. The study had been published in early 1982, and the intention had been to introduce such a tax in the 1982/83 budget. The effect of the publication had been to cause a boom in sales of durable goods in the first half of 1982. When in fact none of the taxes mentioned in the report were introduced in the 1982/83 budget, there had naturally been a considerable decline in retail activity. What the people as a whole had not realized was that there were already widespread sales taxes in New Zealand, but they were built into the sales price of goods and were not added on. The authorities were somewhat concerned by the impact of a widespread sales tax on costs. They did not wish any addition to the cost of goods or an increase in the consumer price index to be translated directly into wages. For that reason the authorities had allowed direct taxes to rise with price increases, instead of adopting widespread indirect taxes. Moreover, the authorities were concerned at the high administrative cost of a value-added tax and, to a lesser extent, of a sales tax. The matter had however not been dismissed; it was still regarded as an option.

Executive Directors had perhaps given the New Zealand authorities less than their due in commenting that they had been following short-term policies, Mr. Morrell considered. They had made, for instance, great efforts in connection with energy conservation and development. There had been large programs to promote the use of natural gas instead of imported oil; programs to convert motor vehicles to use of compressed natural gas and liquified petroleum gas; and the construction of major projects that would result in a considerable reduction in the reliance on imported oil products. A significant proportion of the country's debt had in fact been devoted to capital-intensive energy projects which would shortly start to produce a return; they would offer a net pay-off within the next few years.

The Acting Chairman made the following summing up:

Directors noted that New Zealand's economic situation had deteriorated since the previous consultation. The evidence of the deterioration was to be found in an increase in the external current account deficit to a projected level of 7 per cent of GDP in FY 1982/83, rising unemployment, and the persistence of inflation at a rate considerably in excess of that prevailing in the main trading partners. While economic activity had been quite buoyant in 1981/82 in contrast to the stagnation or decline of activity in many member countries, the expansion of domestic demand by over 6 per cent had clearly been unsustainable. Discussion centered importantly on the decision to freeze prices and wages accompanied by a freezing of interest rates and the level of the effective exchange rate. Most Directors shared the staff's misgivings about the effectiveness of wage and price controls and expressed serious concern about the considerable economic costs which they entail in misallocation of resources. Directors also cautioned that, although the freeze seemed to be holding so far reasonably well, acceptance of it might begin to diminish rapidly if controls were maintained for too long a period.

Directors were encouraged by the determination of the New Zealand authorities not to allow any significant breakout of inflation following the end of the wage/price freeze in June 1983, but they expressed much interest in how this result is to be brought about. Directors stressed that it would be crucially important to maintain a tight stance of financial policies if a re-emergence of inflationary pressures after the end of the freeze was to be avoided. In this context, they underscored the need to give high priority to the restoration of a flexible interest rate policy so as to make possible once again the functioning of an active monetary policy. It was hoped that current controls would prove to be only a temporary reversal of the process of financial liberalization that the authorities had successfully pursued up to early 1981.

Noting that the fiscal deficit is expected to be 6.25 per cent of GDP in the current year and that it would rise to over 8 per cent of GDP in the next year in the absence of corrective action, Directors noted that the New Zealand authorities acknowledged the need for fiscal adjustment and urged the authorities to give high priority to reducing the deficit. It was felt that a determined effort at reducing the steep increase in the Government's expenditures would be essential. However, a number of Directors were also concerned that such efforts may not be sufficient, and they therefore encouraged the authorities to address the issue of tax reform without delay.

Directors welcomed the authorities' efforts at instituting tripartite discussions among the social partners and the Government, but cautioned that there was no substitute for adequately firm financial policies. They expressed the hope that the worsened economic environment would prove to be a spur to all parties to make renewed efforts aimed at breaking down the rigidities in the process of income determination. A number of Directors felt that a more market-oriented approach in this field might prove fruitful, both in raising efficiency and in enhancing employment.

While acknowledging that external factors--including severe protectionist barriers abroad, which over the years had profoundly influenced the economy of New Zealand and therefore the attitude of the New Zealand people and their Government--had played an important role in the deterioration of New Zealand's external position--Directors stressed that domestic policies had been insufficiently supportive of external adjustment. A number of them considered there was a danger that by the end of the freeze a backlog of currency overvaluation might have built up, and, in this context, many Directors stressed the desirability of an early restoration of the system of flexible adjustment of the exchange rate.

While noting that New Zealand continued to have a high rating in international financial markets, several Directors nevertheless cautioned about the dangers of too rapid a growth in external debt and debt service.

Directors noted the substantial program to develop New Zealand's energy resources, but the authorities were encouraged to accelerate the momentum of their economic restructuring efforts, particularly in manufacturing industry, in order to raise the efficiency of the economy and enhance the effectiveness of macroeconomic policy instruments.

While conceding that major progress in reducing protection would be difficult in a period of rising unemployment, many Directors felt that the authorities should nonetheless venture further on the road of import liberalization and of export promotion in the nontraditional sector because it was ultimately in the interest of New Zealand itself. Directors welcomed the agreement on Closer Economic Relations with Australia as a means of moving forward with the process of reducing protection.

Finally, New Zealand's recent move to Article VIII status was welcomed, and the importance of regular Article IV consultations with New Zealand was emphasized.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/83/41 (2/28/83) and EBM/83/42 (3/2/83.

2. GABON - 1982 ARTICLE IV CONSULTATION - POSTPONEMENT

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 Gabon until not later than April 8, 1983. (EBD/83/52, 2/25/83)

Decision No. 7354-(83/42), adopted
March 1, 1983

3. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 82/121 through 82/123 are approved. (EBD/83/46, 2/23/83)

Adopted March 1, 1983

4. EXECUTIVE BOARD TRAVEL

Travel by an Advisor to an Executive Director as set forth in EBAP/83/64 (2/25/83) is approved.

APPROVED: August 12, 1983

JOSEPH W. LANG, JR.
Acting Secretary