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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/109

3:00 p.m., July 22, 1983

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

Executive Directors	Alternate Executive Directors
	W. B. Tshishimbi
	H. G. Schneider
	A. Le Lorier
	J. Delgadillo, Temporary
R. D. Erb	T. A. Connors, Temporary
M. Finaish	T. Alhaimus
	T. Yamashita
	P. Leeahtam, Temporary
R. K. Joyce	D. I. S. Shaw, Temporary
	J. R. N. Almeida, Temporary
G. Laske	G. Grosche
	C. P. Caranicas
R. N. Malhotra	
	J. E. Suraisry
	J. Schuijer, Temporary
A. R. G. Prowse	K. G. Morrell
G. Salehkhou	
	M. Camara, Temporary
	J. L. Feito
J. Tvedt	A. Lindå
	C. T. Taylor
	J. Bulloch, Temporary
	Wang E.

J. W. Lang, Jr., Acting Secretary
R. S. Laurent, Assistant

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Also Present

Asian Department: Tun Thin, Director; U. Baumgartner, D. Burton, S. M. Schadler, B. J. Smith, G. Szapary. European Department: B. Rose, Deputy Director; A. Arimo, P. L. Hedfors, W. L. Hemphill, A. Knöbl, M. Schulze-Ghattas. Exchange and Trade Relations Department: D. K. Palmer, Associate Director; S. Mookerjee, Deputy Director; H. Hino. Fiscal Affairs Department: G. Blöndal, P. S. Heller. Legal Department: A. O. Liuksila, S. A. Silard. Middle Eastern Department: A. S. Shaalan, Director; A. K. El-Selehdar, Deputy Director; J. G. Borpujari, G. Tomasson, S. von Post, L. A. Wolfe. Secretary's Department: L. Collier. Treasurer's Department: A. G. Chandavarkar. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: A. A. Agah, C. J. Batliwalla, S. El-Khouri, P. Kohnert, H.-S. Lee, P. D. Péroz. Assistants to Executive Directors: H. Alaoui-Abdallaoui, M. Eran, G. Ercel, I. Fridriksson, N. U. Haque, M. Hull, A. Juusela, H. Kobayashi, W. Moerke, V. K. S. Nair, Y. Okubo, J. G. Pedersen, G. W. K. Pickering, E. Portas, M. Z. M. Qureshi, T. Ramtoolah, J. Reddy, Shao Z., Wang X.

1. INDIA - EXTENDED ARRANGEMENT - PROGRAM FOR 1983/84

The Executive Directors continued from the previous meeting (EBM/83/108, 7/22/83) their consideration of the staff paper on the program for 1983/84 presented by India under its extended arrangement (EBS/83/130, 6/24/83; Sup 1, 6/24/83; and Sup 2, 7/20/83).

Mr. Malhotra, continuing his remarks from the previous meeting, referred to the staff's observation that the overall budget deficit might increase by up to 1 percentage point. He pointed out that greater recourse to international commercial markets--which, in fact, had been urged by several Executive Directors--and improved absorption of external aid was bound to raise the overall budget deficit as presented by the Fund staff. Furthermore, domestic elements such as provident funds and small savings entered into the computation of the overall budget deficit; while they could be looked at as loans, Government regarded them as important means for resource mobilization. The slight increase in the overall budget deficit should not, therefore, be looked at with disfavor. The important figure was the increase in assets of the domestic banking system on account of lending to the Government. There, a distinction ought to be drawn between a budget that devoted part of its resources to development capital creation and a budget that essentially dealt with regular government expenditures. In India, there passed through the budget large sums of money that, under another system, would go directly from banks into certain industries.

The increase in assets of the domestic banking sector on government account had been kept well under control, Mr. Malhotra considered. He recalled that the Board had expressed the wish that despite difficulties that had arisen in 1982, the Indian authorities should remain within the limit for government borrowing from the banking sector that had been agreed with the Fund. The authorities had succeeded in doing so even though the timely flow of information from 22 states and far-flung offices of the Central Government was not easy. Toward the end of the year, the authorities had had to postpone some expenditures in order to remain within the limits, in the event that the Government's recourse to the banking sector was well below the agreed ceiling.

Some Directors had observed that current expenditures had risen and that the budget was making only a small contribution to the resources needed under the plan, Mr. Malhotra remarked. However, according to Indian budgetary practices, completed plan projects such as schools, hospitals, roads, or bridges were transferred to the nonplan, current side of expenditures, so that with the end of every plan period, there was an increase in current expenditures. The practice constrained the capacity of the current budget to contribute to the development budgets. In India, there had been considerable debate on the need for adequate maintenance expenditure for keeping up the quality of the capital stock in the economy, something that implied ensuring that current expenditures were at reasonable levels. Further, interest payments were treated as part of current expenditure. In India, there was a close correlation between the level of government borrowing and additions to capital stock in the public sector. Therefore, the rise in interest payments was intimately related to the pace of development.

One Executive Director had asked whether the Indian authorities might not do better to adopt a more aggressive policy with regard to agricultural produce in order to reduce the budgetary costs of subsidy and still attain the objective of increasing the use of fertilizer, Mr. Malhotra recalled. The issue had been looked at in the past. The difficulty was that most agricultural workers in India were subsistence farmers without large marketable surpluses. Furthermore, despite additions to irrigated areas, a large part of the agriculture in India was still exposed to the uncertainties of the monsoon. Agricultural planners believed that to increase production it was necessary to promote fertilizer use in rain-fed areas. Farmers without a substantial marketable surplus responded more to lower fertilizer prices than to higher procurement prices. Promotion of fertilizer use was important because any lag in agricultural production could have a major impact on the external accounts.

In all countries, wage bills accounted for a large share of current expenditures, Mr. Malhotra went on. The wage bill depended on the number of people employed and their level of remuneration. Over the years, the Indian authorities had followed a policy of restraint in wages. Mechanisms did exist for neutralizing part of the cost of living increases, but it was not common for 100 percent of the increases to be compensated. In pursuit of social objectives, the wages of officials in the upper ranks of the Indian bureaucracy had been strictly controlled. By contrast, the authorities had followed a policy of raising salaries of the lower-paid employees within feasible limits.

While some Directors had remarked that pricing policies had been effectively pursued, Mr. Malhotra said, one or two observations gave the impression that overall progress in that area had been inadequate. Although the situation was not ideal, the authorities had made a major effort that deserved recognition. For instance, petroleum prices had risen, on average, to above international levels. Several price increases for coal had been effected, and in the previous two years there had been three major increases in railway tariffs. The price of steel had been increased several times. Cement pricing had undergone important changes. In addition, while there had been lags in certain states, electricity charges had been repeatedly increased. Finally, the price of fertilizer had been increased by 65 percent, although subsequently it had been reduced by 7.5 percent.

Turning to the contribution of public sector enterprises to planned financing, Mr. Malhotra noted that, while the contribution of the non-financial enterprises in 1980/81 had been only Rs 16.6 billion, by 1983/84 it would rise to Rs 45.5 billion, an increase of almost 200 percent. In addition to increasing the prices of their goods and services, those enterprises had also improved their efficiency considerably.

Reference had been made to the need for the public sector enterprises to generate more internal resources to pay for their investment needs, Mr. Malhotra noted. In that connection, he drew attention to a table on page 108 of the latest report dated April 11, 1983, presented by the World Bank to the Consultative Group on India, which provided information on the contribution made by public sector energy enterprises to their investment needs, apart from customs duties and excise taxes paid by them. Internal resource generation by those enterprises had been about 13 percent in 1975/77 or Rs 2.6 billion, compared with total investment of Rs 19.2 billion. By contrast, in 1981/82, internal generation had totaled Rs 15.7 billion, compared with an investment level of Rs 38.5 billion, so that internal resource generation in energy enterprises had risen to about 45 percent of total investment.

Several comments had been made on India's import policy, Mr. Malhotra remarked. Despite a difficult international environment and internal difficulties owing to increased competition from abroad, the authorities had not only maintained their liberal import policy but had advanced it further. The staff had judged those advances to be significant.

Some observations had been made that the general structure of import controls remained in place, Mr. Malhotra recalled, thus implying that there had been no substantial progress. That was not his view. On the contrary, the progress in import liberalization had been very substantial. Mr. Polak, while making a suggestion for a more radical approach, had observed that the major issue was not whether India could move to a much more open system but rather whether the efficiency in Indian industry could be improved. The availability of imported inputs was no longer a constraint on the efficiency of Indian industry. It had been suggested that the authorities should change the present system of import regulation by raising tariffs considerably. Even today, duties on capital goods entering India were relatively lower than on several other goods. For revenue reasons, India had had to keep tariffs fairly high, and pushing them still higher could have adverse implications for the manufacturing sector. Overall, the liberalization of import policy had greatly increased competition for Indian industry.

While noting the increase in technical foreign collaboration, some Executive Directors had asked whether financial capital would also be welcome, Mr. Malhotra said. Foreign financial investment in India was permitted under present regulations. Indeed, the authorities had encouraged Indian industrialists to seek potential foreign investors in important areas of industry. The authorities were interested in financial investment, which was usually accompanied by needed technology. The investment climate in India was favorable in that the profitability of industry, both indigenous and foreign, was good. A number of foreign firms were operating in the country. The authorities had consistently followed the policy that, once foreign investment was permitted, the repatriation of profits, dividends, and capital had to be freely allowed. India's record in that respect had been impeccable.

The Indian authorities had followed a prudent policy with regard to commercial borrowing, Mr. Malhotra considered. Even so, the debt service ratio would rise considerably, from less than 10 percent to 22 percent, partly because the Indian authorities had had to increase their recourse to World Bank financing, due to large cuts in IDA credits. At the same time, they had had to borrow more on the international capital markets.

Finally, in the light of Miss Le Lorier's observations on the distinctive nature of the Fund program with India, Mr. Malhotra said, the prospective underlying adjustment in the real sector would fully justify the enlarged access to the Fund's resources. His authorities hoped that they would succeed in achieving the objectives of the program.

The Chairman observed that 1982/83 had been a year of external shock for India; there had been droughts and a sluggish international environment, so that incomes in agriculture had declined in real terms by 2 percent, hardly a favorable trend in an economy so heavily dependent on agriculture. GDP had indeed increased, but only by 1-2 percent in real terms instead of the 5 percent on which the staff and the Indian authorities had based the program.

At times, the Chairman continued, Fund programs with countries fell apart because public savings did not resist the operation of automatic stabilizers. In India, despite the 3 percent negative gap in the growth rate of GDP, public savings had actually risen by 0.5 percent of GDP. The result was extremely commendable, especially as it had been accomplished by a host of individual measures on the budget and on pricing in particular. One of the main goals in the program had been to increase public savings.

The central government deficit had deteriorated somewhat, by half a percentage point compared with the preceding year, but the preceding year had been one of strong expansion in the economy, the Chairman continued. Bank financing of the states' budgetary deficits had actually been less in terms of GDP than the previous year; the authorities had had less recourse to the banking sector and thus more recourse to real savings. Inflation had been kept under control. Indeed, the results had been better than initially foreseen.

Some sources of concern had been identified by Executive Directors, the Chairman recalled. First, while it was understandable that the position of the Central Government had slipped somewhat, the authorities should be extremely cautious not to let some current expenditures, in particular subsidies, creep into the central government budget and weaken it. Regrettably, the current position of the budget was deteriorating; in 1981/82, the first year of the Fund program, there had been a slight surplus in the current budget, but it had been in deficit since 1982/83, and the position was not expected to improve in 1983/84. The size of the deficit would be heavily dependent on the interest payments that the Government would have to finance as well as on its own expenditure. Executive Directors had indicated that they would like the subsidy element of the expansion of current expenditures to be kept under strict control.

Second, almost all Executive Directors had said that the states still had a good deal of action to take in order to raise the public tariffs of the enterprises and utilities functioning under their direction to realistic levels, the Chairman said. Such action could not only improve the position of the states but also foster more capital investment in the sectors mentioned by Mr. Malhotra. As irrigation and energy were crucial to the future of the economy, it was understandable that, at the start of the third and last year of the Fund program, some Executive Directors were somewhat concerned to see that the Indian authorities had not done more under those headings, although they had recognized that an enormous amount of real investment had taken place since the inception of the plan.

The Fund staff had been working diligently with the Indian authorities on import liberalization, the Chairman noted. The extent of liberalization had not satisfied all Executive Directors, but the Indian authorities had achieved great progress in the past few months. They had originaly pledged to liberalize the import regime substantially; only when, after long negotiations, the Fund management had felt that the additional actions taken were satisfactory had it brought the report to the Board. In a difficult international environment, there had been movements in the right direction. The authorities should move more rapidly and decisively, perhaps relying less on complex administrative mechanisms.

Finally, the balance of payments was still a weak feature in the Indian economy, the Chairman concluded. The debt was not worrisome at present, but it was moving upward. The Indian authorities were well aware of that development, which represented one of the constraints under which they had to operate. He was sure that they would continue to be cautious in managing domestic demand, particularly in light of their external constraints.

The Executive Board then took the following decision:

1. India has consulted with the Fund in accordance with paragraph 4(d) of the extended arrangement for India (EBS/81/198, Sup. 3, 11/13/81), as amended (EBS/81/198, Sup. 4, 2/24/82; and EBS/82/102, 6/11/82), in order to reach understandings with the Fund regarding policies and measures that India will pursue through March 31, 1984.

2. The letter dated June 8, 1983 from the Minister of Finance of India, together with the annexed Statement of Policies shall be attached to the extended arrangement for India, as amended, and the letters dated September 28, 1981 and June 8, 1982, together with the annexed Statements of Policies, shall be read as supplemented by the letter dated June 8, 1983.

3. Accordingly, India will not make purchases under the extended arrangement from July 22, 1983:

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

(i) the ceiling on total domestic credit as specified in paragraph 5 of the Statement of Policies annexed to the letter dated June 8, 1983; or

(ii) the ceiling on the net credit to the Government as specified in paragraph 5 of the Statement of Policies and annexed to the letter dated June 8, 1983 is not observed; or

(b) if India fails to observe the limits on official contracting and guaranteeing of nonconcessional loans as specified in paragraph 16 of the Statement of Policies annexed to the letter dated June 8, 1983; or

(c) during any period after January 29, 1984, until the review with the Fund contemplated in paragraph 3 of the letter dated June 8, 1983 has been completed, or if following that review, any performance criteria established by the Fund pursuant to the review are not observed.

4. Paragraph 4(d) of the extended arrangement for India shall be amended to read as follows:

(d) for the period from April 1, 1984 to the end of the extended arrangement, if before June 30, 1984, suitable performance clauses for this period have not been established in consultation with the Fund or if such clauses, having been established, are not observed; or....

5. Purchases under the extended arrangement for India shall not, without the consent of the Fund, exceed the equivalent of SDR 3,900 million until June 30, 1984, provided that purchases shall not exceed the equivalent of SDR 3,100 million until October 30, 1983; the equivalent of SDR 3,300 million until January 30, 1984; and the equivalent of SDR 3,700 million until April 30, 1984.

Decision No. 7473-(83/109), adopted
July 22, 1983

2. NORWAY - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with Norway (SM/83/120, 6/8/83; and Sup 1, 6/15/83). They also had before them a report on recent economic developments in Norway (SM/83/142, 6/30/83).

Mr. Tvedt made the following statement:

Following a high rate of growth--an annual average of 4.75 percent--during the 1970s, GDP rose only marginally in 1981 and declined by 0.5 percent in 1982. This change in the rate of growth was mainly the result of the international recession, more restrictive domestic policies, and a halt in the increase in oil and gas production.

Manufacturing production has--as noted by the staff--been stagnant for several years, reflecting weak world demand for major Norwegian exports, deterioration in Norway's foreign competitiveness, and transfers of productive resources to the oil and service sectors.

Unemployment remained low during the 1970s--in the range of 1-1.5 percent of the labor force--as the growth of employment in the oil industry and in the service sectors, particularly in the public sector, more than compensated for the decline of employment in manufacturing. Reflecting the slowdown in the economy, the rate of unemployment has been increasing in the last two years and reached 3.7 percent, seasonally adjusted, in the first quarter of 1983.

The rate of inflation, which had been close to the average level for the industrial countries during the 1970s, accelerated sharply following the 1978-79 wage-price freeze and reached 13.7 percent, as measured by the consumer price index, in 1981. The rate of inflation has since decelerated but is still higher than the average for industrial countries.

Recent economic developments indicate few major changes from the forecasts provided in the staff report. The trough of the recession was probably reached in the first quarter of 1983, but there is still little evidence of recovery. Industrial production, the volume of retail sales, and building and construction activities were stagnant or declining in the three-month period February-April. On the positive side, the rate of inflation is declining somewhat faster than projected at the time of the consultation discussions, and the balance of payments has developed more favorably than expected at that time.

The expansionary elements in the economy are now mainly investments in the oil sector and exports. The incipient international recovery has already manifested itself in an increase in the volume of "traditional" exports (merchandise exports excluding ships, oil rigs, and oil and gas). These exports, seasonally adjusted, rose by 5.4 percent between the fourth quarter of 1982 and the first quarter of 1983, and new export orders as well as the business survey by the Central Bureau of Statistics indicate that exports will be the main growth factor in the near-term future, a pattern quite normal in the early stage of a recovery in Norway. The recovery is expected to gather momentum in the second half of 1983, and for the year as a whole GDP is still projected to rise by 2 percent, provided that gas and oil production is maintained without interruption. The projected rate of growth will not be sufficient to reduce unemployment, which--although low compared with other industrial countries--is of great concern to the authorities.

The wage negotiations in the spring of 1983 resulted, as noted by the staff, in a 0.7 percent increase in wages in the private sector, on an annual basis. Allowing for wage overhang from 1982 and projected wage drift, wage earnings in the private sector are now expected to be 7.75 percent higher on average in 1983 than in 1982, implying a wage increase of 6 percent between the fourth quarter of 1982 and the fourth quarter of 1983. Taking into account an increase in productivity of about 2 percent and the depreciation of the Norwegian krone in the fall of 1982, relative unit labor costs in manufacturing industry are estimated to improve by 3-4 percent from 1982 to 1983.

The rate of inflation has declined faster than expected at the outset of the year. Consumer prices rose by 8.8 percent in the 12-month period to June 1983, and on average they are now expected to be 8.5-9 percent higher in 1983 than in 1982. By December 1983, the 12-month rate of growth in consumer prices may come down to 7 percent.

As noted above, the balance of payments has developed more favorably in 1983 than expected just a few months ago. Current account data, now available for the first quarter of 1983, show a surplus of NKr 3.5 billion, compared with a surplus of NKr 2.8 billion in the first quarter of 1982. Data for the trade account, which are available also for April and May, show an NKr 12.5 billion surplus for the first five months of 1983, compared with a surplus of NKr 7.6 billion in the corresponding period the previous year. The improvement in the trade balance is mainly due to a 19 percent increase in the value of exports of oil and gas--reflecting both higher volume and higher prices in Norwegian kroner--a 12 percent increase in "traditional" merchandise exports, and stagnant imports, excluding ships and oil rigs. Although imports are expected to rise during the remainder of the year, the prospect is now for a current account surplus in 1983.

The outlook for 1984 and the medium-term future has not changed much since the consultation discussions in Oslo. Reflecting a more optimistic view on the recovery of the world economy, the outlook for the growth of the econmy and for the external current account may be slightly better than at the time of the consultation discussions.

The Norwegian authorities agree with the staff that price inflation is a major problem in the Norwegian economy, and that efforts to reduce inflation should not be relaxed. The authorities regard the wage settlements negotiated in the spring--although on the high side--as a step in the right direction. Through income tax reductions and various measures to stimulate competition, the Government hopes to reduce further the rise in wages and prices. Reduced subsidies to ailing industries and restructuring of the economy will also contribute to this end. The Norwegian authorities agree with the staff that these more direct anti-inflationary measures have to be supported by firm demand management policies. However, these policies have to be viewed in relation to the cyclical conditions in the economy. With a small open economy, Norway is extremely exposed to changes in international trade. The fiscal countermeasures that have been taken for 1983, have to be viewed in this context. The authorities, however, agree with the staff that the present fiscal deficit excluding oil taxes of something over 7 percent of GDP should not be allowed to increase further.

As for credit policy, the medium-term intention of the authorities remains that of moving toward a more market-oriented policy. However, in view of the depressed level of investments in the non-oil industries and the decline in interest rates in other countries, steps have been taken to lower interest rates. Moreover, given the expansion in bank lending so far this year, and in the light of the interest rate reductions, direct regulation of lending has been implemented in order to ensure compliance with the lending quotas set out in the credit budget. All these measures have been amply described in Supplement 1 to SM/83/120.

Turning to exchange rate policies, I can only confirm that the authorities, as noted in SM/83/120, "intend to keep the exchange rate of the krone fixed for longish periods and to adapt domestic policies as needed in order to cope with changed internal and external circumstances." Changes in the present currency basket system are not contemplated.

The Norwegian authorities are firmly committed to free trade. The trading system is liberal, except for trade in agricultural products and textiles. Because of climatic and geographic conditions, regulation of imports of agricultural products is felt necessary to maintain a reasonable minimum degree of self-sufficiency in such products. Like in other industrialized countries, the protection of the textile industry is maintained in an attempt to enable this industry to restructure its production and to build up a viable base for its activities. The Norwegian textile industry is located in sparsely populated areas where it is especially difficult to develop alternative employment possibilities. The Norwegian authorities are at present engaged in negotiations with a view to acceding to the MFA III.

Finally, the Government intends to maintain at a high level Norway's official development assistance (ODA), which is estimated to amount to 1.1 percent of GNP in 1983.

Mr. Feito noted that economic events and policies in Norway were still dominated by changes in the sectoral composition of aggregate supply and demand brought about by developments in the oil and gas sectors. The Appendix to SM/83/142 dealing with oil and macroeconomic adjustment summarized the theoretical issues associated with oil discovery and gave an excellent description of the Norwegian economy. There appeared to be no escaping the phenomenon whereby a boom in one traded goods sector squeezed profitability in other traded goods sectors by directly bidding sources away from them and by placing upward pressure on the exchange rates. Both those features were present in Norway.

Although, theoretically, policies could be designed to enlarge the economic base by expanding the oil sector without disrupting the existing sectors of production, in practice the development of the oil sector had been achieved at the expense of sectors producing other export-competing goods, Mr. Feito considered. Oil export proceeds were expected to place upward pressures on the nominal exchange rate of the krone and also on domestic prices. The appreciation of the real exchange rate would tend to squeeze sectors other than oil, which were exposed to foreign competition more than the sectors producing nontraded goods and especially nontraded services. Thus, in a small, open economy like that of Norway, the booming oil sector had led to a considerable decline in the relative size of exports and in competing industries; Norway was undergoing deindustrialization, or, more accurately, oil-based industrialization. As shown in Table 42 of SM/83/142, the aggregate of export-oriented and competing industries, which had represented almost 28 percent of real non-oil GDP in 1973, had declined to only 22 percent by the end of 1982.

Structural changes of that magnitude over a relatively short period had triggered great uncertainty, Mr. Feito continued, while displaced factors of productivity and declining industries had put pressure on the formulation of economic policy. The evolution of the market had reflected those changes in the economy. For instance, as a result of the relative growth of the sector producing domestic goods and services, a much larger share of the labor force had become subject to the relatively low productivity growth characteristic of sectors producing nontraded goods and services. Nevertheless, the growth of wages in different sectors had not been in line with productivity developments; wages in low-productivity sectors, particularly in ailing industries, had tended to reflect the demonstration effects of wages achieved in more dynamic sectors. Together with the accommodating stance of demand policies, wage developments appeared to account for most of the inflationary pressures that had been domestically induced in the past few years as well as for the growing unemployment. As the staff had mentioned, some 17 percent of the industrial work force was employed in firms in which the wage bill exceeded total value added.

The dynamics of productivity and wage response were at the heart of most of Norway's economic problems, Mr. Feito considered. Thus, he was encouraged by the emphasis recently placed by the Government on the need for wage negotiations to take due account of economic conditions in different sectors. Particularly important was the principle set by the Government that in industries receiving selective support, wages should increase by less than the average. The Government should be commended for taking measures to stimulate competition in the goods and labor markets, and for dismantling subsidies to ailing industries as well as recently reducing the income tax. There did seem to be a discrepancy between Mr. Tvedt's unconcern and the staff's concern at decisions to increase support for particular industries.

Important as they were, those and similar measures would fail to exert a lasting influence on wages unless they were accompanied by prudent nominal demand policies, Mr. Feito remarked. In recent years, demand management policies had accommodated the pressures emanating from changes in the supply side, so that the rate of inflation in Norway had been higher than that in its main industrial trading partners despite the appreciation of the krone during the period. To the extent that there existed a trade-off between inflation and unemployment, in view of the high welfare costs attached to each additional percentage point of unemployment, the authorities might have been somewhat more justified in accommodating part of the internal and external shocks affecting the economy. In a small, open economy like that of Norway, however, any trade-off of that sort was short-lived. Thus, the rates of both unemployment and inflation had moved up in the recent past.

The authorities should take account of Norway's experience in formulating policies for the period ahead, especially if the incipient recovery, which seemed to be gathering momentum, was not to be aborted, Mr. Feito concluded. He fully shared the staff's emphasis on the need for firm demand policies. Given the cyclical deterioration in Norway's fiscal position, monetary policy should be somewhat stricter than was implied in the present projections. Mr. Tvedt's comments on credit policy suggested that investment and activity in the non-oil sectors were sensitive to high interest rates. Could the staff delineate the relative responsibility of the public sector and the evolution of real wages in the poor performance of private investment in the non-oil sectors of the Norwegian economy?

Mr. Schuijer commented that Norway's economic position was unique among western European countries, combining as it did substantial energy resources with an unemployment rate quite low by international standards. Perhaps more than any other European country, Norway had pursued a policy of safeguarding employment by keeping domestic expenditure high, a tradition partly inspired by geographical factors and low labor mobility. As Mr. Vidvei had pointed out during the 1982 Article IV consultation, one of Norway's economic policy goals was a fairly dispersed settlement of population. While such a policy could entail support to ailing industries, especially when entire towns depended on them, it might also tend to produce such structural rigidities as an awkwardly functioning labor market and low productivity.

In the mid 1970s, in accordance with traditional policies, the Norwegian authorities had chosen to shield themselves from the global recession by spending the country's prospective oil proceeds domestically, Mr. Schuijer noted. The country had subsequently had to adjust to the diminishing domestic focus of its non-oil sector. Domestic demand had expanded, and, as the economy had been operating close to capacity, the domestic price level and the real exchange rate had risen. The result had been a considerable shift in output and employment from tradable sectors to less tradable ones like services.

The staff papers conveyed the impression that Norway had gladly accepted the benefits of the spending option but had insufficiently adapted to its drawbacks, Mr. Schuijer went on. The shifts in the structure of production, caused by the appreciation of the krone in real terms, had been countered by support to ailing industries. After 1978, the real appreciation had been caused mainly by a deterioration in relative unit labor costs, suggesting that part of the worsening of competitiveness could have been prevented by a more cautious incomes policy. Eschewing direct interference in wage bargaining, the Government influenced it instead by offering tax cuts. The danger was that, while public finances might indeed be adversely affected, the policy still might not achieve its goal. Indeed, the staff had suggested on page 7 of SM/83/120 that the increase in unit labor costs expected in 1983 would probably be in line with the increase expected in Norway's main trading partners and would thus be insufficient to improve competitiveness. Although he agreed with the staff that Norway's exchange rate policy was appropriate, the authorities would find it easier to pursue the policy if they brought domestic policies more into line with it.

In a recent address to the supervisory council of the Norges Bank, Govenor Getz Wold had appeared rather optimistic about the opportunities for the non-oil sector in Norway to benefit from an upturn in the world economy, Mr. Schuijer recalled. He feared that present policies might hamper such an upturn in Norway and would appreciate comments from the staff or Mr. Tvedt. After all, an increase in Norway's large structural unemployment might develop in spite of all attempts to depress it by specific measures. The use of proceeds from oil exports to finance a highly developed system of social security could add further to existing labor market rigidities. He had been interested in the recommendations of the Skaanland Commission, which seemed to come close to suggestions made in the Board at the 1982 Article IV consultation with Norway; several Executive Directors had then suggested that Norway should adopt a more cautious version of the spending option and should invest more of its oil earnings instead of spending them. Specifically, Mr. Erb had suggested that only the value added should be treated as a flow of international income and that the remainder should be treated as proceeds from the sale of an asset, which could be invested abroad to reduce the external debt. In general, it was appropriate for a major exporter of one particular commodity to invest a substantial part of its export earnings, particularly since commodity prices were volatile.

The staff had stated on page 7 of SM/83/120 that, after the devaluations of the Swedish krona and the Finnish markka, there had occurred an automatic adjustment of the effective exchange rate of the Norwegian krone, so that Norway's average competitiveness had remained unchanged, Mr. Schuijer noted. It was true that the effective exchange rate had automatically adjusted, because Norway's valuation basket was trade weighted, but the degree to which the country's competitiveness could be maintained depended primarily on the extent to which Norway competed with Sweden and Finland on international markets. If it did compete in certain sectors, the Swedish and Finnish moves were indeed likely to have affected Norway's competitiveness.

He welcomed the authorities' intention to prevent the fiscal deficit before oil taxes from increasing beyond 7 percent of GDP, Mr. Schuijer concluded. Monetary policy had been rather underdeveloped in Norway; interest rates were determined in an inflexible manner, and the authorities' open-market policy was a rather recent phenomenon. He agreed with the staff's recommendation on interest rates. Was it true that the open-market policy was hampered by the market's perception that government bonds were generally less attractive than private bonds? Finally, he was pleased to note that Norway continued to provide a large quantity of official development assistance.

Mr. Suraisry expressed agreement with the staff analysis and conclusions. The Norwegian economy had adjusted well to the structural change caused by the development of the oil sector and the impact of the oil recession: growth was expected to pick up later in 1983, unemployment remained low by current international standards, the overall fiscal position was strong, and the current account would probably again be in surplus in 1983. He welcomed the authorities' continuing efforts to restructure the economy and strengthen the position of the non-oil sector; the task was difficult and would take time, especially in view of the problems facing traditional industries. A recent Royal Commission had made useful and interesting recommendations, which could form a sound basis for a long-term strategy designed to smooth out adjustment in the non-oil sector and to lay the foundations for more broad-based growth in the future. In that way, Norway would be able to derive the full benefits from its present oil-related advantages.

In the immediate future, as part of that strategy, priority should be given to reducing inflation, which remained well above the rate in other major countries, Mr. Suraisry continued. It would be particularly important to restrain the growth of labor costs in order to maintain competitiveness in the manufacturing sector in the short term and to create new opportunities for growth and employment in the medium term. He hoped therefore that the Government would set an example of wage moderation and do everything in its power to encourage firms to link wage increases more closely to gains in productivity. Lower inflation would also require a cautious financial policy of the kind outlined in the staff appraisal. In particular, the likely weakening of the revenue position in the coming fiscal year underlined the need for restraining government spending.

The authorities were to be commended for maintaining a liberal trading system, Mr. Suraisry concluded. He also commended them for an excellent effort on foreign aid, which was expected to reach the equivalent of 1.1 percent of GDP in 1983.

Mr. Schneider expressed general agreement with the staff appraisal. During the past few years, the overall performance of the Norwegian economy had been commendable. Prudent policies had enabled the country to absorb a reduction in oil earnings with little difficulty.

The staff had focused on the main problems of the economy, which included slow deindustrialization and an ensuing rise in unemployment, Mr. Schneider went on. Between 1974 and 1982, output had indeed fallen in the export sector, mainly in industries, by 4.5 percent, while employment had fallen by 13.5 percent. To such ailing industries the Government had accorded considerable support, which, together with excessive wage increases in the recent past, explained why inflation had failed to drop substantially. He agreed with the staff that the authorities should improve the Norwegian public's understanding of the relationship between the cost of labor and the rate of unemployment if they did not wish to intervene directly in wage negotiations in the private sector. As the Government had stressed that, in industries receiving selective support, wages should increase by less than the average in manufacturing, could Mr. Tvedt indicate whether the Government was already applying that condition in individual cases? It was his belief that the authorities should set an example in their public sector wage policy as well. Wage moderation was an essential feature for obtaining an improvement in profitability and labor-intensive investment in order to allow Norway to pursue its policy of full employment.

In view of Norway's balance of payments position, he agreed with the authorities that the exchange rate had only a limited role to play in that area, Mr. Schneider remarked. However, the results of recent wage negotiations made it even more necessary to adopt cautious financial policies.

In recent years, Norway had followed prudent monetary policies and had shifted gradually to a less regulated system, Mr. Schneider went on. Along with the staff, he would caution against any attempt to lower interest rates further through administrative measures. Since interest rate costs were tax deductible and since real interest rates had remained negative--apparently stimulating high demand for credit by households--he wondered whether there was in fact one interest cost for households and another for enterprises. It would be useful to learn how much credit had been absorbed by households and how much by enterprises, taking also into account that the credit markets were unregulated. Of course, except for the oil sector, investment had been relatively flat in 1982 and 1983. In conclusion, he could support the staff's assessment of Norway's exchange rate policy, and he agreed with the proposal to put Norway on an 18-month consultation cycle.

Miss Le Lorier said that she was in agreement with the staff appraisal and could also agree that the next Article IV consultation with Norway should take place on an 18-month cycle. She fully concurred with the staff that there were no foreseeable difficulties in the evolution of the Norwegian economy. Clearly, Norway had fully digested the complexities of living with oil and natural gas and in particular appeared to have discovered the limits to relying on a single sector. However, as a result of the new uncertainties related to the future evolution of oil demand and prices, the limits seemed to have become subject to unpredictable moves. For instance, Norway was expected to register a current account deficit equivalent to 0.5 percent of GDP for the first time in four years, despite an economic policy stance that, by Norwegian standards at least, could be regarded as restrictive. While, after the inclusion of oil revenue, the budget was expected to be in surplus, the surplus would not exceed 2 percent of GDP in 1983, a low figure by previous standards, and it was expected to be less in 1984. It could therefore be argued that the present orientation of policy in Norway might be insufficiently restrictive.

It was unclear whether the need to improve Norway's competitiveness in the export sector was being well served by the present trend in wage settlements, Miss Le Lorier continued. The trend might reflect the authorities' intention not to interfere in private negotiations, but moderation in private sector wage requests was not being encouraged by the Government's broadly accommodating monetary policies or by its fairly generous wage settlements in the public sector. The risks of rekindling inflationary pressures could not be overestimated. The sensible policy of stabilizing the exchange rate of the krone for an extensive period could not be carried through without triggering costly capital movements. While there was little justification for a pessimistic reading of the papers on Norway, the authorities should consider a longer-term reorientation of policies geared to strengthening the export sector and reducing the imbalances currently offset by oil revenue.

Mr. Taylor noted that Norway had experienced a significant relative deindustrialization during the previous decade, and in the past few years manufacturing output had actually fallen. The relative loss of industrial capacity, as shown in Table 42 of SM/83/142, had been so great that non-oil tradables, which had accounted for 28 percent of non-oil GDP in 1973, had declined to about 22 percent. The drop had been considerable, although less so than in some countries, like the United Kingdom. At any rate, the change in the economic structure had been attributable to Norway's having emerged as a major oil and gas producer, and, more recently, to the effects of the world recession. Although the oil sector was not particularly labor intensive, Norway had been comparatively successful in limiting the rise in unemployment. Nevertheless, with oil production likely to continue to rise throughout the 1980s, the maintenance of a satisfactory rate of unemployment would depend on the authorities making some effort to strengthen the exposed non-oil sector further; the staff was correct in observing that the economy's ability to support the present standard of living in the longer run would depend on the maintenance of a viable and active non-oil tradable sector. In other words, it would be necessary at least to maintain, and preferably to improve, Norway's international competitiveness in the non-oil sector, partly through moderating the rise in costs and prices--including those in the sheltered sector, which tended to have a large influence on developments in the exposed sector--and partly through improving productivity. The staff might well be correct in maintaining that the external sector was unlikely to pose a serious constraint on the economy in the short and medium term; as Miss Le Lorier had pointed out, the long term might be different. In the meantime, the authorities would have to pursue prudent fiscal and monetary policies consistent with moderate growth in demand and restraint on labor costs.

Norway's current account was projected to be in surplus during 1983, given the strong growth in non-oil and oil exports so far, Mr. Taylor observed. Thus, the policy of exchange rate stability backed by appropriate domestic policies appeared entirely suitable. Nevertheless, the authorities would find it useful to retain flexibility in the exchange rate should pressures on relative prices and costs develop in the future. They would need to watch developments in wages and productivity growth, and should pay some attention to boosting productivity in the non-oil exposed sector, an objective that would require both an active level of investment and moderation in wage settlements.

In manufacturing, wage growth had been somewhat excessive in relation to productivity growth, but the picture seemed to have improved recently, Mr. Taylor noted. He was glad to have heard from Mr. Tvedt that inflation might fall to 7 percent by the end of 1983. It was nevertheless important to maintain restraint on wage increases. He would agree with the staff that recent agreements with the public sector unions seemed somewhat generous. In future, perhaps the Government could--without becoming too embroiled in wage bargaining--give a stronger lead in the public sector, especially if inflation slowed, as the authorities expected. To some extent, weak productivity growth could be linked to labor market rigidities, such as reluctance to lay off skilled workers, and also to a high degree of legally based job security. He had noted that the Appendix to SM/83/142 said that industrial support schemes greatly helped to prevent more fundamental structural adjustments, which would otherwise have been the inevitable consequence of the emergence of a developing oil sector. Moreover, appropriations for specific industrial support--having been reduced in the draft budget for 1983--had subsequently been increased with a view to offsetting adverse effects from devaluations of the Swedish krona and the Finnish markka. While he understood the authorities' wish to mitigate the harsher effects of deindustrialization, they would nonetheless do well to concentrate on industries likely to remain viable in the longer run.

With regard to fiscal policy, Mr. Taylor said, he agreed that the deficits should not be allowed to increase further, if they did, they could create problems for the control of credit expansion. Therefore, he fully agreed with the staff's call for "utmost restraint on the expenditure side." On the revenue side, real property taxes and taxation of property income were relatively low in Norway, and interest payments on loans were fully deductible from gross taxable income. Did the authorities show any inclination to move on those matters? The Governor of the Norges Bank had made some comments to that effect in a recent speech. Higher property taxes and a reduction in the tax deductibility of interest charges might enable the authorities to reduce indirect taxes, with consequential benefits in slowing retail price increases.

Given the relaxation of fiscal policy, an incipient easing of credit policy could be inappropriate, Mr. Taylor said. He was in agreement with the thrust of the staff appraisal.

He had appreciated the explanation given by the staff for its recommendation regarding the timing of the next Article IV consultation with Norway, Mr. Taylor concluded. Could it become standard practice to include such an explanation in circumstances in which the normal 12-month cycle of consultation was not adhered to?

Mr. Grosche observed that Norway was one of the countries that had not only been blessed by large oil revenues but also been confronted with the difficulties that such revenues imposed on a country in adjusting its economy. Unlike other such countries, however, Norway had begun as early as 1978 to pursue less spending-oriented policies, the results of which had been surpluses on the external and fiscal balances and substantial repayments of foreign debt. However, many problems still persisted. Real GNP had declined in 1982, and only a moderate recovery was projected for the second half of 1983. Although the rate of inflation in Norway was expected to continue to decline to 6-7 percent by mid-1984, it would still be higher than in major industrial countries. Unemployment had been increasing during the previous two years, partly because of cyclical factors, but structural factors might have played an even more important role. Although the oil sector had provided an increase in employment and wages, it had also left the rest of the exposed sector in a weak competitive position, thus diminishing employment opportunities. Unemployment would have been even higher if the public sector had not been expanded by special employment-creating schemes and large subsidies to ailing industries.

To achieve the desired improvement in competitiveness, there should be restraint on the growth of labor costs, Mr. Grosche continued. He agreed with the staff that restraint on wage claims in the private sector would be encouraged if the Government adopted a more cautious line in its wage settlements. He wondered, however, whether the proposed income tax reductions would help to bring about a moderation in nominal wage increases. Experience had shown that the authorities of any country could not easily rely on a trade-off between income tax reductions and modest wage settlements.

Norway's fiscal performance had been mixed, Mr. Grosche considered. Because of oil revenue, the central budget continued in surplus, but on a shrinking scale. The authorities believed that a looser fiscal policy was warranted in the light of growing unemployment. Excluding oil revenues, they estimated the deficit at 7.2 percent of GDP, compared with the original target of 5.7 percent. However, he did not believe that fiscal relaxation would help to bring about an immmediate increase in competitiveness; on the contrary, the decision to increase support for particular industries ran counter to solving Norway's longer-term problems. Thus, he shared the reservations expressed by the staff.

On monetary policy, Mr. Grosche went on, he would like to ask whether the staff considered the reduction of interest rates by administrative action, effective July 1, to be in line with the staff's own recommendation for a strict monetary policy. In his view, monetary policy should continue to pursue a cautious stance in order to consolidate the progress achieved in lowering inflation and to reduce inflationary tendencies further. Moveover, he supported the staff's view that credit markets, and interest rates in particular, could probably be made more flexible by replacing or removing present administrative restrictions.

He agreed with the staff that Norway's external position gave no reason for concern in the short run, Mr. Grosche remarked. As Mr. Tvedt had indicated, the latest figures showed a better current account performance in the first months of 1983 than had been expected. However, the medium-term outlook was less favorable, the current account was expected to move into modest deficits during the next few years. They could even increase substantially unless the country maintained appropriate competitiveness. Considering the authorities' relatively inflexible stance on exchange rate policy, they would have to rely on financial and wage policies to achieve their objective.

Mr. Tshishimbi remarked that, like previous speakers, he was in broad agreement with the staff appraisal. As the Norwegian external position gave no grounds for particular concern, the only difficulties for the authorities were domestic ones. He also agreed to an 18-month cycle for Article IV consultations with Norway.

Over the previous several years, the economy of Norway had performed fairly well, and a strong momentum resulting from the 1978 reorientation of economic policy had enabled the country to adjust smoothly to the current turbulent world environment, Mr. Tshishimbi observed. Despite the worldwide recession, output had recorded high growth rates, and unemployment had remained quite low until recently. The external current account had been in surplus for the past two years, but, in 1982, the economy had begun to show some signs of difficulty, and real GDP had declined, while the external sector had begun to weaken, and unemployment had risen. Wage increases and other pressures seemed to have contributed to keeping the inflation rate high. He agreed with the staff that the authorities had little room for relaxing the anti-inflationary effort. As Norway had an open economy greatly dependent upon developments in foreign markets, the authorities would have to continue to follow sound and flexible monetary and fiscal policies. He therefore shared the authorities' view that protectionist measures should be eliminated and trade liberalization should be stepped up with a view to further enhancing world trade.

He welcomed the reaffirmation of the authorities' commitment to increasing official development assistance (ODA) to 1.1 percent of GDP under the 1983 budget, Mr. Tshishimbi continued. Although ODA was not the only means of helping developing countries, it was certainly one of the most important means of providing much-needed assistance to many of them, especially the least developed.

Mr. Prowse also expressed support for the conclusions in the staff report. The fact that a country had access to substantial oil revenues clearly should not alter the framework used in analyzing its economy. The recommendation for an 18-month cycle for future Article IV consultations had been framed on the assumption that Norway's external position would give no grounds for concern. While the focus on a country's external position was obviously appropriate for the Executive Board, Directors should reflect on the proposal for the staff to explain all recommendations for not adhering to the standard 12-month consultation cycle, before adopting a procedure. There were more pitfalls than might be immediately obvious, and he was not sure whether, each time the staff recommended a 12-month or 18-month period between consultations, it should have to explain precisely why.

Norway's position as a significant oil producer had proved of enormous assistance to its balance of payments and fiscal positions, Mr. Prowse considered. In a purely financial sense, Norway was in better shape than many other European countries, not to mention those elsewhere in the world. Regrettably, the authorities' response to the growth of the oil sector had contributed to structural problems in the Norwegian economy and had disguised a growing fiscal imbalance. For example, the oil income had placed upward pressure on the exchange rate for the krone and had encouraged the financing of strongly expansionary policies, which had in turn accommodated domestic cost and price pressures. Moreover, the growth of the oil sector had contributed to a deterioration in competitiveness in Norway's exposed sector by leading to cost and price increases. Indeed, as the staff noted, output and employment in the exposed sector had fallen substantially since the mid-1970s. The Government's principal response to the decline seemed to have been to postpone structural adjustment and increase protection to inefficient industries. For Norway's longer-term growth, employment, and perhaps external viability, the authorities ought to increase the efficiency of the exposed sector by encouraging structural adjustment to proceed.

Throughout the mid-1970s, much of the oil and gas wealth accruing to Norway had been used to finance rapid growth in government expenditures, much of which had been used to prop up declining industries and make large income transfers, Mr. Prowse remarked. While there had been some tightening in fiscal policies since 1978, progress had been limited. As other Directors had noted, excluding oil tax revenue, the central government deficit stood at about 7 percent of GDP, one of the highest figures in the OECD. The Norwegian authorities' immediate objective--reducing the growth of public expenditure to facilitate the transfer of resources back to the private sector--was laudable, but it seemed to have been slow to operate. In that respect, the operation of fiscal policy since September 1982 seemed disappointing. He therefore strongly endorsed the staff's call for the Norwegian authorities to exercise the utmost restraint on government expenditure, particularly in view of a forecast decline in revenue from oil and income taxes.

Monetary policy appeared to have made little contribution to the management of the Norwegian economy in recent years, Mr. Prowse considered. The move to a market-oriented monetary policy in 1980 was welcome, but much remained to be done. Moreover, the measures taken in early June 1983 might well be contrary to the movement toward freeing the financial markets. At any rate, after-tax interest rates in Norway were still negative. The inflation of wages and prices remained unacceptably high and was eroding the competitiveness of the exposed sector. Those developments reflected accommodating monetary and fiscal policy and the high level of government support to inefficient industries. He therefore strongly endorsed the staff's judgment that there was no room for relaxation of the anti-inflationary thrust, and that monetary policy had to be made firmer. Norway had supported the application of incomes policies in the light of the staff's contention that the rate of inflation had remained high largely as a result of strong wage-push; he would be interested in hearing from the staff or Mr. Tvedt how effective wage and incomes policies had been in Norway.

On the external scene, the staff expressed satisfaction that Norway's trading system had remained substantially open, Mr. Prowse noted. Unfortunately, massive subsidies were distorting trade flows and slowing structural adjustment as well.

On page 13 of SM/83/120, the staff had agreed with the Norwegian authorities that a policy of keeping the exchange rate for the krone fixed for longish periods was appropriate, Mr. Prowse observed. That sort of policy assumed a large degree of flexibility and adaptability in domestic policy. While accepting that Norway had an enormous capacity to maintain its present position because of oil revenue, he nonetheless found the staff's policy recommendation to be remarkable. Perhaps the staff or Mr. Tvedt might wish to discuss the exchange rate further.

Mr. Wang congratulated the Norwegian authorities on their economic achievements. Despite the unfavorable external environment, especially the recent fall in the price of oil, the current account of Norway's balance of payments had been in surplus for the past three years and was expected to be in moderate surplus again in 1983. The Central Government would have repaid the entirety of its foreign debts by the end of 1984, and the foreign exchange reserve position remained comfortable.

On the other hand, inflation and unemployment were still matters of concern, Mr. Wang went on. He agreed with the staff that the authorities should not relax their efforts to reduce the rates of price inflation and unemployment further.

The authorities deserved commendation for their commitment to free trade and their excellent record on foreign aid, Mr. Wang remarked. Norway's official development assistance had equaled 1 percent of GNP in 1982 and was expected to reach 1.1 percent of GNP in 1983, a figure well above the UN target of 0.7 percent. In conclusion, he agreed with the staff's proposal that the next Article IV consultation with Norway should be on an 18-month cycle.

Mr. Connors expressed agreement with the analysis in the staff report and generally endorsed the policies recommended to reduce inflation further and to bring about substantial structural changes in the economy over the longer term.

While the recently reported unemployment rate was high compared with previous rates, he feared that disguised unemployment and underemployment were much higher than reported, Mr. Connors continued. A great deal of inefficient production had to be taking place, as shown from the staff statement that some 17 percent of the industrial work force was employed in firms where the wage bill exceeded total value added. He therefore strongly endorsed the staff view that there was a need to hold labor costs down in ailing industries and to withdraw support from unprofitable sectors, as the authorities indeed intended to do. Such policies should help to induce shifts into sectors that were relatively more competitive.

Second, there appeared to be room for improving the functioning of credit markets through greater flexibility and less administration, Mr. Connors said. The developments reported in SM/83/120, Supplement 1 were not encouraging in that regard. The growth of lending was likely to be better controlled through the use of the more flexible interest rate policy than through the present policy of warning banks that their lending would be brought under direct control if credit growth exceeded specified targets. In conclusion, the authorities should encourage foreign competition in the banking sector to increase efficiency.

Mr. Malhotra noted that Norway's policies, both monetary and fiscal, had been appropriately adjusted. The country was also following a broadly open trading policy. The country's record in providing official development assistance had been most commendable.

There were some structural problems in the economy, as noted by several Executive Directors, Mr. Malhotra went on. Certain industries appeared uncompetitive, partly because of high wages. Moreover, several industries, which had probably become uncompetitive, were being supported through government actions. That was the major structural problem confronting the authorities; it did appear that they were aware of it and hoped to tackle it.

Turning to exchange rate policy, Mr. Malhotra commented that he had been intrigued by the staff comment cited by Mr. Prowse. He did not fully understand the implications of the passage and would be glad if the staff explained more fully. In conclusion, interest rates would continue to require the attention of the authorities.

Mr. Camara noted that the 0.5 percent decline in Norway's real GDP during 1982 had reflected the impact of the global recession on the domestic economy. Despite the authorities' efforts to support employment, the rate of unemployment continued to increase. He welcomed the recent positive developments reported by Mr. Tvedt, including an expansion of output in the export sector, a marked decline in the rate of inflation, and favorable developments in the balance of payments. The basic underlying problem was the erosion of the competitiveness of manufacturing industries caused by higher costs of production and upward pressures on prices and wages. Together with a weak cyclical position, those factors had triggered a continuous increase in unemployment.

On the fiscal front, the staff called for firm demand management policies and the utmost restraint on expenditure in order to keep inflationary pressures under control and achieve the Government's medium-term aims, Mr. Camara continued. Nevertheless, while the authorities agreed with the staff on the importance of restrained fiscal policy in controlling inflation, they were inclined to put more emphasis on the continuation of incomes policies to reduce any upward pressure on prices and wages. He could understand the authorities' intention to use fiscal policy to stimulate production and expand employment. Given the strong fiscal position reflected in the overall budget surplus and the constant spending/GDP ratio during the past two years, he hoped that the stimulative fiscal policy would not reinforce inflationary pressures. Although the tax reduction and the elimination of subsidies to ailing industries, together with the restructuring of the economy, were expected to improve supply-side performance and enhance the expansion of output, he agreed with the staff that lasting improvements in employment and production would require measures to improve productivity in longer-term problem areas of the Norwegian economy.

The staff seemed to be urging the authorities to adopt a restrictive monetary policy with more emphasis on broad monetary and credit aggregates as targets and with uncontrolled interest rates, Mr. Camara said. In many industrial countries, such market-oriented policies had proved effective tools of economic management, especially in helping to influence the public's inflationary expectations. By contrast, in countries in which institutional realities permitted an effective implementation of policy on incomes and wages, the authorities should find it possible to achieve the same effect on the public's inflationary expectations by adopting such policies. At the same time, the authorities of such a country could use administered interest rates and qualitative as well as quantitative credit controls to promote investment, as the Norwegian authorities were apparently trying to do.

Despite the difficult economic situation in recent years, Mr. Camara concluded, the Norwegian authorities had continued to increase official development assistance to 1.1 percent of estimated GDP in 1983, a figure well beyond the U.S. target for ODA. A number of countries in his constituency were among the beneficiaries of Norwegian aid, and they appreciated not only the high level of assistance, but also the principles behind it.

The Deputy Director of the European Department explained that the staff report might have dwelt on the problems being experienced by the Norwegian economy to an extent that had disguised the good features of the economy such as the current account surplus and a budget surplus. For instance, Mr. Prowse might have been a little harsh in saying that the Norwegian authorities spent all of their revenue on higher welfare payments and massive subsidies to industry. It was true that subsidies had increased, but the authorities had had to decide how to spend the extra real income accruing from sales of North Sea oil. They could of course have set up a foreign investment fund and spent only the income from that fund. He himself, however, could not see anything wrong with the authorities' having chosen what was known in Norway as the spending option. The authorities should of course be careful to maintain some margin; in the past two years, Norway had perhaps come somewhat close to using up the margin.

On monetary policy, Mr. Grosche had asked whether the recent action taken by the Norwegian authorities in reducing rates administratively had been in line with the staff views, the Deputy Director continued. The answer was "no." Nevertheless, it was not accidental that, in SM/83/120, Supplement 1, the first paragraph had dealt with the formation of a new coalition Government and the second had dealt with certain steps taken to adjust interest rates. Many Directors appeared to have supported the staff position that monetary policy should be stricter and that it should be modernized. After all, Norwegian policy still retained characteristics that had first become evident 30 years previously. There was a fair amount of support in Norway for a more market-oriented policy. Instead of considering what benefits such a policy would have, he would prefer to examine what damage was being done by the present system. The main cause of damage was enormous administrative complication. A so-called gray market had sprung up in credit. The Norwegian authorities had attempted to bring the gray market under control and, as experience in other countries had demonstrated, another type of market would probably spring up. The disadvantages of a policy so complex to administer and difficult to understand outweighed the advantages that might be obtained from the selective direction of credit.

Several Executive Directors had obviously been uneasy about the practice of granting concessions on taxes in the hope of obtaining moderation on wages, the Deputy Director noted. The staff had raised the matter in its discussions with the Norwegian authorities and had been told by one senior official that he had fully shared the staff's skepticism but had to admit that, on the present occasion, the wage settlement had in fact been moderate, a development that would probably encourage the authorities to repeat the experiment. The staff itself believed that the authorities were fully aware of the dangers that tax concessions might be granted without securing moderation in wage settlements. It was extremely important that the Government should give a lead in the public sector. The contractual settlement in the private sector had been 0.7 percent, and estimated drift was expected to be 5 percent. By giving public sector employees roughly the same rate increase, it had in effect been inventing the concept of drift in the public sector, which was clearly undesirable. On incomes policy, the present Norwegian authorities believed that intervention in private sector settlements would do more harm than good.

He would agree that more structural adjustment was needed in Norway, and some Directors had been critical of the pace at which it had taken place so far, the Deputy Director said. Nevertheless, great progress had been made. In textiles, the market share of domestic firms had fallen from 40 percent to 28 percent since 1975, while employment in the industry had fallen by 17 percent. In shipbuilding, employment had fallen by 19 percent. While it could be argued that the shifts should have occurred more rapidly, it was traditional in Norway to maintain a high standard of full employment, and the Norwegian authorities had confronted a difficult dilemma in employment ever since the oil sector had become prominent in the economy.

A question had been asked about the reasons for the low rate of investment in Norway, the Deputy Director recalled. The main reasons for low investment in the non-oil sector appeared to be the low capacity utilization and the high rate of wage increases.

As to Mr. Prowse's question on exchange rate policy, the Deputy Director noted that the fact that Norway had had a fixed exchange rate from 1978 to 1982 had not so far as he knew occasioned particular interest in the Executive Board. In the light of the recent devaluation, the staff had raised the question whether the authorities had changed their previous policy and whether they were now intending to adopt a more flexible exchange rate policy. The staff had accepted the statement by the authorities that such was not their intention. Of course, if they failed to control the growth of labor costs, they would have no alternative but to devalue. Nevertheless, they knew that a fixed rate for a rather long period imposed a certain sort of discipline. It meant that they would be compelled to adopt certain domestic policies if they were to keep the exchange rate for the krone stable. What they wished to avoid was a situation in which exchange rate depreciation was followed by an offset in money wages, followed by further exchange rate depreciation.

At the most recent discussion that had taken place in the Board on the exchange rate of a Scandinavian currency, the Executive Board had expressed great concern that Sweden had used exchange rate policy in an overaggressive manner, the Deputy Director continued. He had thought that the statement by the Norwegian authorities that they did not intend to use the exchange rate aggressively but rather would make every effort to adapt their domestic policies would have been received gratefully by Executive Directors. After all, the decision by Norway not to change its exchange rate following the devaluations by Sweden and Finland had produced an automatic adjustment of the Norwegian krone against other currencies; it had also caused difficulties for particular industries in Norway.

A question had been asked by Mr. Schneider about how much credit was reserved for householders as opposed to enterprises, the Deputy Director of the European Department stated. He regretted that he did not have the information necessary to answer the question. Mr. Taylor had raised the matter of the deductibility of interest payments and the low rate of real property taxes in Norway. It was true that real property taxes were low, far below the OECD average, and were in fact levied on only 10-15 percent of the market value of the property concerned. Together with the full deductibility of interest expenses, the low rate of property taxes did, in his view, badly distort the credit market in Norway. While almost all economists in Norway realized that the practice was not helpful either in promoting better resource allocation or in helping to maintain the fiscal balance, there was a lack of political support for a change in the property tax system and the system of interest deductibility.

The Deputy Director of the Exchange and Trade Relations Department observed that the reasons for recommending a departure from the normal 12-month cycle had to be that one or more of the three criteria established by the Executive Board for the standard 12-month cycle were not being met.

Mr. Tvedt recalled that several Executive Directors had noted that interest rates had been lowered through administrative means recently and also that direct regulation of lending had been imposed. Regrettably, the Norwegian Cabinet had just introduced direct regulation of commercial bank lending as well.

A broad-based committee was reviewing the tax system as well as the transfer system, Mr. Tvedt went on. The most important aim for economic policy at present was to slow the rise in prices and costs in order to strengthen Norway's competitive position. In that connection, the implementation of measures that might limit the authorities' room for maneuver should be avoided. He hoped that economic developments, both internationally and in Norway, would be such that the main emphasis could be shifted from measures aimed at preventing higher unemployment in the short term to measures designed to restructure the economy and strengthen competitiveness, thus safeguarding employment in the medium and longer terms. The main tasks for those preparing the national budget for 1984 would be to draw up a fiscal and credit policy allowing the money supply to support the current level of economic activity without rekindling inflation. The economic policy pursued in the coming year would probably be one of gradualism.

The Chairman made the following summing up:

> Executive Directors noted that Norway did not face an immediate external constraint. However, the rate of inflation, though now falling, still exceeded the average for major countries and thus posed a potential problem for the maintenance of competitiveness.

Directors noted that while Norway's registered unemployment rate, at over 3 percent of the labor force, was low by international standards, it was high by Norwegian standards. They pointed out the structural weaknesses that had developed in the Norwegian economy. The emergence and growth of the oil sector had entailed a reallocation of resources in the economy, weakening the competitive position of the other sectors. The strategy pursued since the mid-1970s, known as the oil spending option, while protecting employment, had also contributed to a weakening of productivity in the economy and to the decline of the manufacturing sector.

Directors noted that high subsidies to ailing industries hampered structural change and labor mobility and thought that, in the medium and long run, the size and efficiency of the exposed sector had to be increased. Therefore, international competitiveness needed to be at least maintained, and labor costs in the whole economy needed to be restrained. For this purpose, they stressed the need to follow firm demand management policies.

Directors noted that, because of oil revenues, Norway had had an overall fiscal surplus for a number of years. The continued recession had made some weakening of the fiscal position understandable in 1983, but Directors felt that the fiscal stimulus should not be increased any further--some put it a little more strongly--because of the impact that an increase could have on the rate of credit expansion and on inflation. Looking further ahead, Directors urged the utmost restraint on the growth of public expenditure, which as a proportion of GDP had remained among the highest in the OECD countries.

Some Directors noted the existence of an extensive system of tax deductibility for interest payments and wondered whether this aspect of the tax system was warranted in the light of the need to strengthen demand management.

Directors considered that in monetary policy the Norwegian authorities should assume a strict stance, given the need to make further progress in reducing the rate of inflation. They thought that the system of monetary management was still somewhat overcomplex despite some movement toward a more market-oriented policy since 1980. Greater emphasis could usefully be placed on the development of broad monetary and credit aggregates and on more flexible interest rates responsive to market forces. In this connection, noting that interest rates after taxation were negative, Directors regretted the recent measures to lower interest rates by administrative action and to increase the extent of credit rationing. They thought that there would be a danger of misallocation of resources in the longer run unless the system of interest rate determination and credit allocation were made more flexible.

There was some expression of skepticism about the advisability of providing tax concessions in order to obtain more moderate wage arrangements. Directors, in any case, considered that the authorities should set an example for wage moderation in the public sector, and some regretted that the stance on public sector pay had not been firmer in the recent past.

Directors noted Norway's generally open trade policy with satisfaction, and they commended Norway for maintaining its exemplary record in foreign aid.

It is expected that the next Article IV consultation with Norway will be held by January 1985.

3. KUWAIT - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with Kuwait (SM/83/133, 6/20/83). They also had before them a report on recent economic developments in Kuwait (SM/83/151, 7/7/83).

Mr. Finaish made the following statement:

The principal aim of economic policy in Kuwait continues to be to make an effective use of its oil export receipts as a means to the achievement of sustained and diversified growth. This policy has been reflected in the channeling of a large proportion of oil revenue into investment in infrastructure and industry at home and into the acquisition of a variety of income-yielding assets abroad. The growth of domestic expenditures was particularly rapid during the latter half of the 1970s. While these expenditures permitted high rates of growth in the non-oil sectors, they also led to inflationary pressures and inefficiency in resource use, partly because domestic absorptive capacity could grow only relatively slowly. These developments, coupled with the consideration that oil reserves were depletable, led to some restraining of expenditure growth toward the end of the decade and to the placing of greater emphasis on conservation in oil production policy. The latter was reflected in the setting of a medium-term ceiling on crude oil production at 1.5 million barrels a day just before 1980, compared with the actual production level of 2.5 million barrels a day in 1979; the ceiling was further lowered to 1.25 million barrels a day in 1981. This ceiling was also considered to be broadly consistent with the economy's medium-term financial requirements.

Developments in the international oil market since 1981 have, however, necessitated a further reorientation of financial policies toward restraint. Reflecting the large contraction of world oil demand during this period, Kuwait's crude oil production fell to 1.1 million barrels a day in 1981, significantly below the ceiling set in that year, and further to 825 thousand barrels a day in 1982.

The volume of oil exports fell by about one third in each of these years. While the strength of the country's foreign reserves and assets provides a cushion against such developments necessitating abrupt adjustments, the authorities have been quick to perceive the need for further measures aimed at expenditure restraint and rationalization. Their response has helped to keep overall government finances and the balance of payments in surplus, despite the large drop in oil receipts. The policy of relative financial restraint has also been instrumental in keeping the annual increase in consumer prices down to about 7 percent in recent years.

A major objective of the strategy of industrial development has been the development of a fully integrated oil sector under national ownership and control, and a large part of investments made in the past has been allocated to that end. Investments have been made in expanding domestic refining capacity as well as in extending energy exploration activities and retail distribution networks, the latter two involving the acquisition of--or participation with--several foreign oil concerns. Ongoing projects aim at refining more than one half of crude oil output at the medium-term ceiling of 1.25 millon barrels a day by 1986. At the same time, high priority has been given in the investment strategy to the development of downstream industries to complement the production of oil and gas. In this regard, a number of facilities have been established that produce a variety of petrochemicals, including fertilizers. The development of industries other than those based on hydrocarbons--mainly construction material and transport equipment industries--has in recent years been left to the private sector, with the Government providing encouragement through assisting in the provision of infrastructure and financing.

Reflecting the authorities' efforts aimed at economic diversification through industrial development, manufacturing output has grown at an average annual rate of about 15 percent over the past five years. While the pursuit of this policy has been vigorous, the authorities have been placing increasing emphasis on careful project selection so as to avoid new ventures with costs of production significantly higher than those of competing imports.

The main development in the fiscal area over the past two years has, of course, been the budgetary impact of the large drop in oil revenues. Total government receipts fell by about one third in 1981/82, with receipts from the two major sources--namely, oil and investments--dropping by 37 percent and 22 per cent, respectively. Since the fall in receipts could not be matched by any reduction in the pace of expenditure growth during the year, the overall surplus in government financial operations recorded a steep fall from close to 50 percent of

GDP to 9 percent. A further weakening of the fiscal position--possibly the emergence of a deficit--was, however, avoided in 1982/83; with a further drop of 10 percent in oil revenue being offset by an increase in investment income, the containment of expenditures in response to the previous year's developments is in fact expected to result in a moderate increase in the surplus--to about 12 percent of GDP--through reducing total expenditures by a significant margin in absolute terms. For 1983/84 the overall surplus is projected to be similar to that of 1982/83 as the policy of expenditure restraint is being continued under the 1983/84 budget and, in addition, a moderate turnabout is expected in oil revenue.

As part of their policy to rationalize government expenditures, the authorities have been considering ways of reducing the outlay on subsidies, especially those relating to energy items. A notable measure taken in this respect in 1982 was a sharp increase in the domestic prices of gasoline, kerosene, and diesel fuel.

Partly reflecting the slower growth of government net domestic expenditure in 1982, traditionally the main determinant of monetary developments in the Kuwaiti economy, domestic liquidity expansion decelerated sharply to 8 percent during the year. Data for the first few months of 1983 point to a further significant contraction in liquidity growth. As domestic liquidity expansion had been rapid over the previous few years, the marked slowdown in it in 1982 seems to be appropriate. It also appears to be consistent with the credit needs of the productive sectors in light of the slowdown in economic activity.

Prior to 1982 the Central Bank had taken a number of measures to restrict the extension of bank credit for stock market speculation as well as to limit banks' own involvement in stock purchases, recognizing the possible dangers inherent in the rapid buildup of speculative activity in the country, especially in the unofficial stock market. As noted in the staff report, several additional measures to this end were announced by the Central Bank in early 1982. By limiting the risk exposure of banks to the stock market, these measures were instrumental in protecting the domestic financial system--safeguarding its liquidity and solvency--from the adverse repercussions of the serious difficulties that began to emerge in the unofficial stock market in the latter half of 1982. The boom in stock market speculations was financed mainly by a form of credit creation based on postdated checks that lay outside the control of the monetary authorities. In order to prevent a recurrence of such a situation, a high-level committee is currently in the process of introducing reform measures to improve the organizational and regulatory provisions relating to stock market transactions. At the same time, steps have been taken to expedite the settlement of claims arising from past transactions.

In the external sector, while the value of oil exports fell by more than one half between 1980 and 1982, the impact on the balance of payments was somewhat cushioned by two factors: namely, a sizable increase in investment income in 1981 and the deceleration of import growth resulting from fiscal restraint. While these factors have helped to maintain a significant surplus on the current account, the estimate of KD 1.8 billion for 1982 is much below the peak of KD 4.4 billion reached in 1980. The current account surplus is tentatively projected to decline to about KD 1.5 billion in 1983. This forecast includes an assumed 13 percent increase in oil export volume during the year.

With respect to reserve management, the authorities continue to be guided by considrations of liquidity, security, and yield, while avoiding large and abrupt portfolio adjustments in response to short-term changes in interest or exchange rates. It is noteworthy that despite the weakening of its balance of payments position, Kuwait has not reduced its official assistance to developing countries, most of which continues in the form of grants. Official development assistance amounted to as much as 6 percent of GDP in 1982.

Mr. Suraisry expressed general agreement with the staff appraisal. Despite recent weaknesses in the international oil markets, Kuwait, unlike many other oil exporters, had managed to remain in a comfortable financial position. Both the budget and the balance of payments had recorded sizable surpluses in the past two years, a result attributable in large part to the authorities' prudent management of the country's foreign exchange reserves. As an outcome of that prudent policy, investment income generated from foreign exchange earnings had almost covered imports in 1982 and had represented about 79 percent of oil revenues. While investment income was subject to developments in the international capital markets, among other things, it nonetheless represented a major achievement by the authorities in pursuing the process of diversification of the Kuwaiti economy.

To adjust to the sharp decline in government revenue, the authorities had followed a restrained policy on expenditure since FY 1982/83, Mr. Suraisry noted. Given the strength of the external sector, the fiscal policy stance was appropriate. Kuwait's still large foreign exchange reserves ought to allow the country to continue to adjust gradually and smoothly.

The stance of monetary policy had been adapted to external and internal economic developments, Mr. Suraisry said. Domestic liquidity expansion had decelerated in 1982, reflecting the slowdown in government expenditure and the consequent slowdown in the growth of non-oil GDP. The authorities had moved swiftly to isolate the impact of the collapse of the unofficial stock market on the banking system, and to minimize its adverse effects on the economy as a whole. Owing to the large size of that stock market, the impact of the collapse on the Kuwaiti economy would have been grave unless the authorities had moved quickly and courageously to bring it under control. Strong measures to regulate and reform stock market transactions and to prevent such an incident from happening again were of paramount importance for the economy not only of Kuwait, but also of neighboring countries. With repect to wage policy, he welcomed the authorities' intention not to increase the salaries of civil servants.

In conclusion, Kuwait was maintaining an open exchange and trade system, Mr. Suraisry remarked, and it had been a generous aid donor. He hoped that the authorities would succeed in consolidating the economy further and would benefit from their affiliation with the Gulf Cooperation Council, which should provide ample opportunities in economic cooperation and planning.

Mr. Malhotra said that he was in broad agreement with the staff appraisal. Kuwait had been blessed with large oil resources, and the authorities had to make an effort to diversify the economy. They had tried to build up infrastructure was well as industries primarily in the oil sector, yet, like many other oil-based economies, Kuwait had been trying to adjust to the evolution of the oil market. He endorsed the staff's view that the fiscal policy stance had been appropriate: despite a sharp reduction in oil revenue, the authorities had managed to keep the budget in surplus. As a result, they had also thought it possible to keep the growth in monetary aggregate under control, especially from 1982 onward. That the annual rate of inflation in Kuwait was about 7 percent underlined the high quality of economic management.

In the light of recent developments, the authorities were not only adjusting their spending policies, but were also increasing the prices of petroleum products by reducing subsidies, Mr. Malhotra noted. In the past, higher prices for petroleum products in oil surplus countries had not proved popular steps; the Kuwaiti authorities' actions underlined their commitment to a thorough review of the budget and fiscal policy. Moreover, the authorities were becoming increasingly selective in choosing development projects. While they might be encouraged to undertake a large investment at a time of large oil surplus, they were wise to be more selective in channeling investments at a time when oil revenue was perhaps less abundant.

The authorities had taken prompt action to cope with the difficulties that had arisen in the private stock market, Mr. Malhotra recalled. It was difficult to develop stock markets, especially when the country's economy had great amounts of liquidity. Historically, speculation had been an element present in many stock markets, but, when it became excessive, it was only appropriate that the national Government should restore discipline. He was certain that if the Central Bank of Kuwait and other financial authorities continued to pay attention to the need for reasonable development of the stock market, it would pay them rich dividends in the medium and long terms.

Kuwait's official development assistance had amounted to as much as 6 percent of GDP in 1982, Mr. Malhotra concluded. The figure was remarkable by any standards, and the authorities were to be commended for it. The Economic Development Fund was a remarkable institution that had been a pioneer in financial assistance.

Mr. Camara expressed agreement with the thrust of the staff appraisal. The Kuwaiti authorities had indeed effected timely adjustment measures. Their pursuit of prudent fiscal policies, together with an appropriate monetary stance and credit management, had cushioned the country somewhat from the adverse impact of fluctuations in the international market price for oil. As a consequence of the sharp decline in oil prices recently, Kuwait's economy--heavily dependent on sales from the large oil reserves--had experienced a loss of revenue of the order of 50 percent, while oil production itself had fallen by 27 percent.

The international results of falling oil prices could be examined from different perspectives, Mr. Camara considered. For developing countries, the gains made in lower oil bills were totally offset by the persistence of high interest rates in the international financial markets. For industrialized countries, by contrast, there had been a substantial and lasting gain. In his view, the relative advantage obtained by developed countries from the moderation of oil prices should help to restore equitable terms of trade vis-à-vis developing countries. Thus, developing countries would benefit from an improvement in the fiscal position of larger industrial countries, for it would trigger a downward movement of interest rates and thus improve less developed countries' ability to import. He would like to reiterate the request that the staff should include in Article IV consultation reports a section elaborating on the impact on other economies of developments in the country under review.

As Kuwait was heavily dependent upon the rest of the world for trade, investment, technology transfer, and labor, there had been serious disadvantages to the country in the wake of the fall in oil prices, Mr. Camara noted. Considering that oil technology was highly capital intensive, a reduction in export proceeds while expenditure continued to rise would be most detrimental. The goal of development in Kuwait, as in most other oil exporting countries, was a sustainable rise in real per capita income and the standard of living, together with increased access to modern advanced technology. The immediate goal, however, was rapid growth and relative price stability. Kuwait's vulnerability to fluctuations in the global demand for oil had increased its need for financial security and product diversification. Oil output had declined considerably; as the commodity tended to be depleted, the Kuwaiti authorities were wise to have taken the decision to await economic recovery in the industrial countries and a consequent rise in the world demand for oil before initiating a significant increase in output. In that connection, it was notable that the national medium-term production ceiling of 1.25 million barrels a day remained in effect. Moreover, the Government was seeking to encourage diversification of domestic production, a decision in line with the long-term needs of the country. Additional efforts should be deployed in subsectors such as agriculture and fisheries in order to maximize the rate of return. He would also encourage the authorities to emphasize human resource development in order to relieve the manpower constraint.

On fiscal policy, he shared the authorities' view of the desirability of further rationalizing resource utilization within the public sector, Mr. Camara said. To that effect, the authorities were planning to reduce the growth of expenditure from 29 percent in 1981/82 to minus 4 percent in 1982/83, so that the overall surplus for 1982/83 would be equivalent to 12 percent of GDP. Fiscal policy would be expected to continue along those lines in 1983/84, and the only foreseeable change would be the eventual diminution of indirect subsidies in the energy sector.

The early speculative price boom had had negative effects on the stock market, and he commended the authorities for continuing to pursue monetary and credit policies aimed at financing nonspeculative activity, Mr. Camara remarked. While encouraging surveillance of overdraft facilities, he would prefer that the authorities eliminate the practice of permitting overdrafts. The effects of the fiscal measures taken had become clear on the monetary side, for domestic liquidity expansion had decelerated to 8 percent from 36 percent in the previous year. On interest rates, he invited the staff to explain the practice of noninterest banking currently emerging in Kuwait and other Islamic countries.

Turning to the external sector, Mr. Camara noted that Kuwait remained in a comfortable position, since its stock of foreign assets was still considerable. He commended the Kuwaiti authorities for their willingness to promote international cooperation. Their dedication to assisting development countries to adjust was encouraging, and he thanked them for the assistance provided to a number of countries in his constituency.

Miss Bulloch commented that it was encouraging to note that non-oil GDP in Kuwait had grown by 5-6 percent in real terms during 1982 and should show little further decline in 1983, despite the costly collapse of the unofficial stock market, which had dealt a serious blow to business confidence and remained a major preoccupation for many businessmen and administrators. The authorities were to be commended for the additional measures taken to protect the banking system from the impact of the crisis. Nevertheless, they might not yet have fully dealt with the aftermath of the crisis as it affected the wider financial community. For example, there was still considerable uncertainty about how the positions of individual debtors would be unraveled. Therefore, she supported the recommendation put forward by the staff that the authorities should take action to reform the organizational and regulatory provisions relating to stock market transactions. Mr. Finaish's information about the activity of the high-level committee and the steps taken to expedite the settlements of claims was welcome. If such measures were fully implemented and supported by substantial public compliance, the authorities should be able to avoid a damaging repetition of recent events.

During 1983/84, the authorities planned to continue with the more restrained fiscal policy stance adopted in 1982/83, Miss Bulloch continued. Figures that she had seen reported were not strictly comparable to those set out in Table 1 of SM/83/133, but they suggested that the National Assembly had indeed cut back planned expenditure for the coming year by 4.6 percent from the level proposed by the Financial and Economic Committee. At the same time, projected revenues, excluding investment income, remained unchanged at a figure corresponding with the information shown in Table 15 of SM/83/151. Excluding investment income, that information implied a budget "deficit" similar to the "deficit" suggested by preliminary figures for 1982/83, again attributable mainly to a shortfall in oil revenue. Of course, unforeseen costs arising from support operations connected with the unofficial stock market prices could add to the "deficit." She had put the word "deficit" in quotation marks because the fairly modest imbalance between government expenditure and revenue would be more than offset by investment income, so that overall the budget would be in surplus.

In contrast to its generally cautious approach to fiscal policy, the National Assembly had rejected the idea that there should be a decrease in subsidies on the consumption of electricity and water, Miss Bulloch remarked. However, she had been glad to hear from Mr. Finaish that the Government's policy continued to aim toward rationalizing domestic energy use and consumption through the progressive adjustment of sale prices toward nonsubsidized levels, and that the removal of subsidies was still under consideration. In that connection, the steps taken during 1982 to raise domestic petroleum prices toward international levels were welcome.

In supporting the conclusions in the staff appraisal, she would add only that the Fund's assessment of Kuwait under its surveillance responsibilities would be facilitated if more complete data on the non-oil sectors of the economy were available, Miss Bulloch concluded. To that end, any further improvement that the authorities could make in providing statistics to the staff would be particularly helpful.

Mr. Connors said that he agreed with the analysis contained in the staff paper. Like other Executive Directors, he believed that action should be taken to reform the organizational and regulatory provisions relating to stock market transactions. He would also support the point made by Miss Bulloch that the authorities should continue to improve their system of data collection.

Mr. Schuijer noted that there were no grounds for particular concern about Kuwait's external position. He therefore wondered why it was being proposed that Kuwait should remain on a 12-month cycle even though Norway, which was not experiencing any difficulties in its external position either, would be shifted onto an 18-month cycle.

The Deputy Director of the Middle Eastern Department recalled that a question had been asked on the practice of offering noninterest-bearing credit under Moslem law. In Kuwait, the financial market was based on interest rates. One organization, the Kuwait Finance House, did engage in what was called Islamic banking, a practice more developed in a country like Pakistan. The basic idea of Islamic banking was that banks provided for equity participation in projects that they financed, so that they would share in the profits of enterprises, a practice permitted under Moslem law.

A comment had been made by Miss Bulloch that the budgetary data in Kuwaiti sources were at variance with the budgetary data in the IMF staff papers, the Deputy Director noted. It was true that the budget presentation in the staff paper was at variance with the official presentation. In Kuwait, by law a certain percentage of oil revenue was deducted directly and placed in a reserve for future generations. Similarly, all earnings from government investments in the two general reserve accounts--the budgetary reserve and reserve account for future generations--were not shown in the budget at all. Whether interest, profit, or capital gains, they were considered extrabudgetary. Thus, the figures used by the Fund would tend to show that Kuwait's financial position was considerably better than the official data would seem to indicate.

As to Miss Bulloch's question about the action taken by the National Assembly in approving the budget for 1983/84, the staff had not reported on that topic because it had been unable to obtain an official version of what had taken place, the Deputy Director of the Middle Eastern Department concluded. His understanding was that the National Assembly had trimmed total expenditures by about KD 300 million.

Mr. Finaish commented that the availability of data on the Kuwaiti economy had improved appreciably in recent years, and the process of improvement was continuing. The coverage of data in respect of sectors such as services and small-scale establishments tended to be unsatisfactory in almost all countries, especially developing countries.

The authorities had moved quickly and effectively in tackling the developments in the unofficial stock market, and the situation was considered to be fully under their control, Mr. Finaish went on. Further organizational and regulatory reform measures relating to stock market transactions were being studied by a high-level committee.

It was true that the relative importance of investment income as a source of foreign exchange earnings had increased considerably in recent years, Mr. Finaish noted. Indeed, investment income had exceeded the cost of total imports in 1981, leading some observers to conclude that the country's current account surplus had become durable and that any developments that might ensue in the oil sector would therefore not reverse the surplus. For instance, Mr. Taylor had observed during the 1982 Article IV consultation with Kuwait that the structural surplus appeared to have become firmly established. Such a reading of Kuwait's prospective balance of payments would appear to have been rather premature. In addition to the cost of imports, Kuwait's current payments included large outlays on services and private transfers, a component that had increased rapidly. Investment income had always fallen well short of total current payments, even in 1981. Second, the level of investment income was variable, being sensitive to changes in the rate of return on foreign assets. Investment income had declined by 19 percent in 1982 and was expected to decline further by 18 percent in 1983, so that projected receipts would be more than one third lower than in 1981. Third, Kuwait's current account position was also dependent on the rate of import growth, which had been quite high on average over many years. The marked drop in the rate of import growth since 1980 reflected the change in the fiscal stance in response to a large decline in oil export receipts. The slowdown in import growth notwithstanding, the current account surplus projected for 1983 would be only one third of that recorded in 1980. It was instructive to note that the surplus would have been completely eliminated in 1983 if imports had continued to increase at a rate close to the average rate between 1978 and 1980. Fourth, even if it were assumed that the balance in Kuwait's current account would remain positive in the near future regardless of developments in oil export earnings, the size of the surplus would be greatly influenced by developments such as those that he had mentioned.

Official economic assistance to developing countries had equaled 5-7 percent of Kuwait's GDP in recent years, Mr. Finaish observed. It had been given mostly in the form of grants and had been untied. Furthermore, it had been distributed widely over a large number of countries in different regions of the world. Despite the sharp drop in Kuwait's oil export earnings during the past two years, the authorities had maintained their level of economic assistance. They intended to continue their aid policy during the period ahead, but the actual level of assistance would have to take into account developments in Kuwait's fiscal position and its balance of payments. Thus, the staff remark that it hoped that Kuwait would continue to provide financial assistance to developing countries on a generous scale could have been qualified to say that Kuwait's ability to maintain recent levels of assistance might be affected by prospective developments in its finances. He also hoped that the staff could extend its plea for generosity to other donor countries as well, especially those whose aid records had weakened considerably in recent years. As the Chairman had noted at UNCTAD, total official development aid had stagnated recently. ODA flows to lower-income countries represented less than 0.1 percent of the GNP of the donor countries, one half of the corresponding ratio 10-15 years previously. He was glad to note that, in some recent consultation documents relating to major industrial countries, the staff had expressed its opinion on the desirability of an increase in aid flows.

Mr. Shaw said that he personally would support placing Kuwait on an 18-month consultation cycle, if it were agreeable to Mr. Finaish.

Mr. Finaish commented that his authorities would be flexible on the point.

The Chairman made the following summing up:

The Executive Directors generally agreed with the views expressed in the staff appraisal contained in the report for the Article IV consultation with Kuwait. They noted the change in Kuwait's economic circumstances brought about by the decline in oil export revenues in the past two years, and observed that the adoption by the Government of a more restrained fiscal policy stance in 1982/83 was an appropriate response to this change. They commended the authorities for having increased the prices of domestic petroleum products, and some stressed the importance of further reducing subsidy outlays.

Executive Directors also noted the developments in Kuwait's unofficial stock market, which had culminated in the market's collapse in August 1982. In this connection, Directors commended the Kuwaiti authorities for the various steps taken to safeguard the domestic financial system from the adverse effects of speculation. They felt that further organizational and regulatory measures were called for in order to prevent the recurrence of excessive speculation.

Although oil export earnings had declined substantially since 1980, Executive Directors observed that Kuwait's external payments position remained strong, owing partly to the high level of foreign investment income. Special note was taken of the fact that the Kuwaiti authorities have continued to provide financial assistance to developing countries on a scale that is most generous by any standard.

It is expected that the next Article IV consultation with Kuwait will be held by January 1985. Some Directors expressed the hope that in particular statistical data on the domestic economy could be further improved on that occasion.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/83/108 (7/22/83) and EBM/83/109 (7/22/83).

4. BENIN - 1983 ARTICLE IV CONSULTATION - POSTPONEMENT

The Executive Board notes the request contained in EBD/83/195 (7/20/83). Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to postpone its consideration of the 1983 Article IV consultation with Benin until not later than September 16, 1983.

Decision No. 7474-(83/109), adopted
July 22, 1983

APPROVED: February 1, 1984

LEO VAN HOUTVEN
Secretary