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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/128

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

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

Executive Directors	Alternate Executive Directors
	J. K. Orleans-Lindsay, Temporary
	H. G. Schneider
B. de Maulde	X. Blandin
	M. Teijerio
R. D. Erb	T. A. Connors, Temporary
	T. Alhaimus
T. Hirao	T. Yamashita
	P. Leeahtam, Temporary
R. K. Joyce	M. Casey
A. Kafka	C. Robalino
G. Laske	G. Grosche
G. Lovato	
	V. K. S. Nair, Temporary
Y. A. Nimatallah	J. E. Suraisry
J. J. Polak	J. Schuijer, Temporary
	K. G. Morrell
G. Salehkhou	
	E. I. M. Mtei
	J. L. Feito
	A. Lindø
N. Wicks	C. Taylor
	Wang E.

A. Wright, Acting Secretary
R. S. Laurent, Assistant

Also Present

African Department: J. B. Zulu, Director; F. d'A. Collings, A. B. Diao. Asian Department: H. O. Roden, S. Shah. European Department: L. A. Whittome, Counsellor and Director; A. Arimo, G. Bartoli, U. Dell'Anno, O. J. Evans, M. T. Hadjimichael, P. L. Hedfors, W. L. Hemphill, H.-J. Huss, A. Knobl, S. Mitra, L. L. Perez, H. O. Schmitt, E. Spitaeller, T. M. Ter-Minassian, M. Xafa. Exchange and Trade Relations Department: S. Mookerjee, Deputy Director. External Relations Department: R. W. Russell. Fiscal Affairs Department: G. Blöndal. IMF Institute: S. N. Stavrou, Participant. Legal Department: G. P. Nicoletopoulos, Director; J. G. Evans, Jr., Deputy General Counsel; W. E. Holder, A. O. Liuksila, S. A. Silard. Research Department: W. C. Hood, Economic Counsellor and Director; N. M. Kaibni, M. D. Knight, T. K. Morrison. Secretary's Department: A. P. Bhagwat. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer; D. S. Cutler, D. Gupta, Q. M. Hafiz, N. Hayashi, T. Leddy, D. V. Pritchett, T. M. Tran, G. Wittich. Western Hemisphere Department: S. T. Beza, Associate Director. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: A. A. Agah, S. E. Conrado, S. El-Khouri, P. Kohnert, H.-S. Lee, Y. Okubo, P. D. Péroz. Assistants to Executive Directors: H. A. Arias, R. Bernardo, J. Bulloch, M. Camara, M. B. Chatah, L. E. J. Coene, R. J. J. Costa, C. Flamant, I. Fridriksson, V. Govindarajan, M. Hull, A. K. Juusela, H. Kobayashi, W. Moerke, G. W. K. Pickering, D. I. S. Shaw, Wang C. Y.

1. EXECUTIVE DIRECTOR

The Chairman welcomed Mr. Xavier Blandin, Alternate Executive Director to Mr. de Maulde.

2. CYPRUS - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with Cyprus, together with a proposed decision concluding the 1983 Article XIV consultation (SM/83/166, 8/1/83). They also had before them a report on recent economic developments in Cyprus (SM/83/174, 8/9/83).

Mr. Polak made the following statement:

> On behalf of the Cypriot authorities I thank the staff for constructive consultation discussions and for a perceptive analysis of the Cypriot economy. The Cypriot authorities agree that the staff has correctly identified the policy issues confronting them.
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> After successful and dynamic adaptation to the new circumstances facing the country in 1974, the economy has been characterized by vigorous expansion and growth of economic activity. By many standards, the performance of Cyprus in recent years compares favorably both with that of the industrial countries and with that of the developing countries. Real GNP has continued to show positive growth--4.6 percent in 1982--and is expected to grow by about 3 percent in 1983. Unemployment remains at about 3 percent. Inflation, as measured by consumer prices, is in the 6-7 percent range. Foreign exchange reserves have increased in the last two years and are at a comfortable level. But these enviable aspects of the economy are accompanied by other aspects that are less satisfactory and are, indeed, a cause for considerable concern: a persistent budget deficit on the order of 6-7 percent of GDP and a current account deficit expected to increase to 8.5 percent of GDP in 1983. Thus, as the staff paper points out, the present situation cannot be considered sustainable, in part because it is out of line with developments in the world economy, and corrective action is needed. Cyprus is in the fortunate position to receive this staff diagnosis, together with a detailed set of policy recommendations, at an early stage and at a time when serious dangers can still be avoided at moderate cost.
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> The immediate problem is to reduce the excess of economic absorption over domestic production. In this effort budgetary policy should take the first responsibility, the more so as there is a clear link running from the budgetary deficit to the current account deficit. Without an improvement in the budgetary accounts, many disequilibria in the Cypriot economy are likely to

remain. A broad range of possibilities presents itself to reduce the deficit by a few percentage points of GDP, such as the introduction of a general sales tax, wage moderation in the public sector, more effective tax collection, the reduction of subsidies, which have more than trebled in the past three years, and moderation of the growth in social transfers, which have also risen, albeit less than social security premiums.

This approach would have to be supplemented by the manner in which monetary policy is conducted. It will be necessary to ensure that central bank targets for the growth of the money supply and domestic credit are adhered to, and that the credit ceilings on loans for trade and consumption are observed. Lending by cooperative credit societies, which amounts to about a quarter of total lending, needs to be brought under the control of the monetary authorities and to be submitted to the same discipline.

To have the full benefit for the Cypriot economy, such straightforward measures to slow down the expansion of domestic demand will have to be underpinned by a number of structural changes. Foremost among these might be two measures: the partial deindexation of wage rates, for example, by excluding from the cost of living index used for this purpose the effects of changes in indirect taxes and in the terms of trade, and correction of the present low interest rate ceiling. The first of these is not only desirable in itself but is also a precondition for any future use of the exchange rate to improve international competitiveness, which has been somewhat eroded by sharp increases in real wages; the second would increase the flexibility and effectiveness of monetary policy and improve the composition of domestic demand.

The Cypriot authorities are considering what choice to make from the considerable array of these and other policy measures presented by the staff in its appraisal, and the timing of this Board discussion is therefore particularly appropriate for them. As they have in the past shown considerable inventiveness and effectiveness in managing the economy, and as that economy has shown a remarkable degree of flexibility in adapting itself to new circumstances, I have no doubt that the authorities will manage to steer the economy toward a more sustainable growth path.

Mr. Taylor said that he shared the concerns expressed by the staff and Mr. Polak about the recent trends in the Cypriot economy. He was glad that the economy had grown, but the growth trend had been mainly consumption led to the detriment of investment, particularly in industry. The consequent erosion of the export base and the excessive growth in imports suggested that such unbalanced growth would probably not be sustainable in the long term. Therefore, he supported the staff's recommendation for a comprehensive effort to moderate domestic demand and restructure the economy so that growth could occur in productive sectors. He welcomed Mr. Polak's statement that the authorities were considering whether to embark on a major reorientation of policy. The possibility of slippages in the implementation of current plans suggested the importance of sustaining the broader adjustment effort into the medium term.

He welcomed the reduction in the fiscal deficit that had been achieved during the past three years, Mr. Taylor continued, but he was concerned that the currently projected deficit in 1983 might easily be exceeded. The Chairman had remarked on several occasions that member countries that persistently ran deficits on the current account of government operations needed especially close surveillance, and Cyprus appeared to be a good case in point. He supported the staff's call for greater efforts to reduce expenditure, particularly current expenditure. Wages and subsidies needed special attention in order to allow room for debt service. He shared Mr. Polak's concern that the growth in social transfer payments, when seen in relation to demographic trends, could generate long-term difficulties, although there were none at present. On the revenue side, he welcomed the authorities' renewed consideration of tax administration and encouraged them to take more resolute action. A broader tax base--including a general sales tax such as the value-added tax (VAT)--and a more selective system of incentives could be beneficial. Moreover, a review of the corporate tax structure could show areas in which the authorities could achieve substantial gains in revenue. An effort to improve the efficiency of revenue collection under the present system could also yield worthwhile results.

The staff had singled out the broadcasting and electricity authorities as having recorded large deficits that had been financed partly from abroad in recent years, Mr. Taylor noted. While understanding the electricity authority's problem in collecting revenue from the northern part of the island, he nonetheless wondered whether the authorities might not provide an explicit subsidy recognizing that specific problem. If such a subsidy were considered impractical or injudicious, what other corrective action might be possible to improve the finances of the broadcasting and electricity authorities?

Interest rate ceilings appeared to be a major impediment to effective monetary management in Cyprus, Mr. Taylor considered, and he would therefore support the staff's call for their early abolition. More realistic interest rates would promote domestic savings and encourage the channeling of those savings through the financial system, thus helping to make credit allocation more efficient, by inducing funds to move into more productive uses and possibly also by moving credit away from its emphasis on consumption. He endorsed the recommendation for stricter enforcement of the current system of credit ceilings. Possibly, where appropriate, the ceilings could be extended to cover more of the financial sector, as Mr. Polak had suggested.

He encouraged the authorities in their attempts to mitigate the adverse effects of wage indexation, which seemed to be fueling consumption and neutralizing efforts to contain domestic demand, Mr. Taylor went on. As the staff had said, at a time when inflation was relatively low it might be opportune to change the indexation element in the system during negotiations for a new social consensus. Real wages were still projected to rise considerably faster than productivity in 1983, thus adding further to the deterioration in international competitiveness that had already marked the Cypriot economy. If the authorities were seriously considering major reforms in the tax system, they might wish to enter into consultations with the trade unions to see whether they could arrive at some kind of consensus through a consolidated package of measures that dealt with both wage indexation and tax problems together.

He shared the staff's concern that the Government's tendency to overshoot in the domestic budget heightened the pressure for further external borrowing, Mr. Taylor said. Therefore, he would encourage the authorities to try to find sources of nonmonetary finance in the domestic economy.

The staff was to be commended for the helpful series of debt service projections for Cyprus expressed as three scenarios in Table 6 of SM/83/166, Mr. Taylor noted. It was exactly that sort of quantitative exercise that could bring the Fund's surveillance role into sharp focus. Incidentally, the case of Cyprus demonstrated the usefulness of the Fund's holding timely and regular Article IV consultations with countries. An exercise such as that in Table 6 gave Executive Directors a valuable early warning of the problems that lay on the horizon. Although the external debt of Cyprus was not yet serious, it could easily become a constraint on domestic policies. After all, even the most favorable scenario in Table 6 projected a rise in the debt service ratio.

The staff's emphasis on the importance of improving Cyprus's international competitiveness was well taken, Mr. Taylor remarked. He would tend to agree with the staff that a strategy of depreciation of the Cyprus pound would not be wholly effective, especially given the institutional arrangements for wage determination. There was thus an even greater need to modify wage indexation.

In sum, he agreed with the staff appraisal and policy recommendations, Mr. Taylor concluded. He supported the proposal that the next Article IV consultation should be held in 12 months, in view of the dangers facing the economy. Incidentally, Cyprus continued to retain its Article XIV status, although it had been a member of the Fund since 1961. He would encourage the authorities to consider moving toward Article VIII status.

Mr. Suraisry said that he was in general agreement with the staff appraisal and could support the proposed decision. Although the authorities were doing well in curbing inflation and in promoting employment and economic growth, they faced difficult problems in several areas. Exports were sluggish, imports were excessive, deficits on the budget and the current account were persistent, and wages were fully indexed.

To deal with those problems, the authorities had announced a policy strategy of correction and consolidation, which he welcomed. He hoped that it would be implemented in a timely and decisive manner, for it was of critical importance to the success of the adjustment strategy.

Liquidity growth had been relatively expansionary and had been a major cause of the surge in domestic demand, Mr. Suraisry continued. He welcomed the authorities' intention to reduce the growth of monetary and credit aggregates, for such a reduction was essential for consolidating the gains achieved in dampening inflation. Strengthening the system of credit controls was a useful step in the right direction, and he hoped that it could be implemented effectively.

The authorities' decision to fix the overall 1983 deficit of the Central Government at the 1982 level was commendable, Mr. Suraisry considered. As the staff noted, the 1982 deficit had been considerably smaller than the 1981 deficit, and reducing the deficit further in 1983 might prove too difficult. However, a gradual narrowing in the deficit through both revenue enhancement and expenditure restraint was essential if the economy was to be stabilized over the medium term. On the revenue side, the tax system should be strengthened and improved. He was encouraged that the authorities had completed a comprehensive study to improve tax administration, and he agreed with many of the comments made by Mr. Taylor. The authorities should also rationalize government expenditures, particularly current expenditures.

Wages were continuing to increase at a faster rate than productivity, partly because of tight labor market conditions but mainly because of full wage indexation, Mr. Suraisry observed. He encouraged the authorities to eliminate those problems, although to do so would not be easy. A combination of tax reform and a low rate of inflation, such as the rate currently prevailing, should make the authorities' task easier.

Restoring the competitiveness of Cyprus was fundamentally important for bringing the economy back to equilibrium, Mr. Suraisry said. However, the authorities would find it difficult to restore competitiveness when a full indexation mechanism remained in place, because any improvement in competitiveness that they might achieve by using exchange rate policy would be of a short-term character. Hence, he agreed that the authorities should give priority to reducing labor costs, a move that ought to have lasting effects. Delay in that vital area would only make the inevitable adjustment more painful.

Mr. Connors expressed agreement with the staff appraisal. He could support the proposed decision, although he did not understand why the authorities continued to restrict foreign exchange for tourist travel. Like Mr. Polak and previous speakers, he thought that there was reason for considerable concern about recent economic and financial developments in Cyprus but that serious problems could be avoided at moderate cost. The staff had made a good case for implementing the policy changes recommended to the authorities: the growth of domestic demand had to be restrained through a reduction in the public sector deficit, expenditure restraint, increases in taxation, and adjustments in certain administered prices in the public sector. Domestic demand should also be restrained through moderation in wage settlements, which, together with a flexible exchange rate policy, would also help to restore the international competitiveness of the economy. He hoped that the authorities could reach agreement with labor to dismantle full wage indexation, a policy preventing smooth adjustment from taking place.

Rates of monetary expansion had to be slowed, Mr. Connors concluded. The implementation of monetary policy appeared to be severely hampered by interest rate ceilings, and he therefore urged the authorities to eliminate them. As a minimum, the authorities should improve the administration of the policy of selective credit ceilings.

The staff representative from the European Department agreed with Mr. Suraisry that time was of critical importance to Cyprus: the indications that the staff had received on economic developments during the past few months gave little cause for reassurance, particularly in the performance of foreign trade. In fact, in the light of developments during the first six months of 1983, Cyprus's trade deficit might turn out to be even larger than projected in the staff report, reflecting the decline in export volumes and a rapid continued growth of imports. She hoped that in the next few months the Cypriot authorities would move promptly toward tightening the stance of fiscal policy and stepping up efforts to reduce some of the rigidities highlighted in the staff report.

In response to a question by Mr. Taylor, the staff representative agreed that it would be better to bring the cost of subsidizing electricity for the northern part of the island explicitly into the budget rather than to have the electricity authority resort to external borrowing in order to finance its deficit. In that way, revenue-raising measures of various forms could be envisaged.

Mr. Polak noted that the electricity authority had been delivering without charge, or rather was not being paid for, the electricity used in the northern part of the island. The authorities in Cyprus would find it difficult to acknowledge the status quo by incorporating into the budget a subsidy for electricity sent to the Turkish sector, since they were unwilling to condone the Turkish occupation.

Finally, Mr. Polak said, he would like to join Mr. Taylor in welcoming the way in which the staff had dealt with the long-term debt projections for Cyprus. The three different scenarios constituted an interesting example of how the matter should be handled.

The Chairman made the following summing up:

> Directors endorsed the thrust of the staff's views contained in the report for the 1983 Article IV consultation with Cyprus. While welcoming the maintenance of satisfactory rates of growth of output and employment and the reduction of inflation in Cyprus

in 1982, Directors expressed concern that the main stimulus to growth came from domestic demand, especially consumption, boosted by a relatively high budget deficit and by an accommodating stance of monetary policy. Directors also noted with concern the maintenance of a rate of growth of real wages far in excess of the growth in productivity and in real wages in Cyprus's main trading partners. This development was seen to have contributed to an unsatisfactory performance of merchandise exports and of productive investment in 1982.

Directors stressed the importance of a timely reorientation of the stance of financial and other economic policies to moderate the growth of domestic demand and imports and to shift resources into the export sector. Such a strengthening of policies was seen as necessary to prevent a further worsening of the current account deficit of the balance of payments, which was fairly high in relation to GDP. The staff's analysis of the medium-term evolution of the debt service of Cyprus was welcomed as a valuable early warning of an emerging problem; this kind of analysis was also viewed as helpful for the fulfillment of the Fund's surveillance role.

Directors called for prompt action to ensure that the budget deficit would be contained to the targeted level in 1983 and reduced significantly in relation to GDP in 1984. This action would have to include broad-based revenue-raising measures and efforts to strengthen tax enforcement and to limit expenditures, notably on civil servants' wages and on subsidies. Directors urged the Cypriot authorities to ensure the strict enforcement of the announced domestic credit policy and to renew efforts to obtain Parliament's consent to the elimination of the existing ceiling on interest rates. They also encouraged the Government to seek a reduction in the degree of wage indexation and moderation in contractual wage settlements. A substantial reduction in the growth of labor costs was seen as indispensable to secure a sustained improvement in competitiveness and in export performance.

It is expected that the next Article IV consultation with Cyprus will take place on the standard 12-month cycle.

The Executive Board then took the following decision:

Decision Concluding 1983 Article XIV Consultation

1. The Fund takes this decision relating to Cyprus's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1983 Article XIV consultation with Cyprus, in the light of the 1983 Article IV consultation with Cyprus conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Cyprus maintains a restriction on the amount of foreign exchange made available for tourist travel. The Fund notes that the authorities intend to relax it as soon as circumstances permit, and in these circumstances grants approval for its retention until the conclusion of the next Article IV consultation with Cyprus.

Decision No. 7511-(83/128), adopted
September 2, 1983

3. SWEDEN - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with Sweden (SM/83/170, 8/3/83; and Cor. 1, 8/24/83). They also had before them a report on recent economic developments in Sweden (SM/83/189, 8/18/83).

Mr. Lindå made the following statement:

On behalf of my Swedish authorities, I would like to compliment the staff for having produced a thorough report. My authorities think that it gives a fair picture of economic developments in Sweden. They particularly appreciate that due attention has been paid to past structural problems as well as those currently facing the Swedish economy. My authorities generally agree with the staff appraisal. However, they have some comments and have also furnished some supplementary information.

As to the most recent economic developments, industrial production in June had risen by 6 percent since August of last year, when the lowest figure had been registered. The unemployment rate has increased in line with expectations and was recorded at 3.4 percent of the labor force in July. An improvement is expected toward the end of the year. As to the external balance, preliminary figures indicate a more favorable outcome this year than earlier foreseen. Thus, the trade balance showed a surplus of SKr 9.5 billion in the first half of this year, compared with the spring forecast of SKr 2 billion for the same period. However, part of this surplus can be attributed to seasonal effects, as exports normally are strong during the spring and imports increase more rapidly during the autumn. There are also other temporary factors to be taken into account, such as increased exports of ships and oil products.

On the inflation side there has been a somewhat more favorable development. From December to June consumer prices rose by one-half percentage point less than expected, or by 4.7 percent. Accordingly, consumer prices are estimated to rise by less than 9 percent during the 12-month period to December 1983.

The Government has stated its aim to reduce the inflation rate to 4 percent in 1984. In achieving this goal, the development of wages plays of course an essential role. In this context, I wish to refer to the first paragraph on page 9 of the staff report regarding wage costs in 1984. In fact, my authorities have not made any statement on the likely outcome of the wage round in 1984. What can be said is that according to recent calculations it would be possible to achieve the inflation target for 1984, provided that wage costs do not increase by more than 6 percent.

On page 3 of the staff report, it is mentioned that in late 1982 relative unit labor costs in manufacturing were about 20 percent lower than at any time in the 1970s. If I interpret Chart 4 correctly, that figure seems to be somewhat exaggerated. What is more important, however, is that the Swedish economy was characterized by external disequilibrium in the base year, 1980, and in most of the 1970s. Furthermore, the relative unit labor cost index was at a very high level during the period in question, especially in the middle and late 1970s. Therefore, a corresponding lowering of the index over an extended period is a prerequisite for attaining a balanced current account position.

The Swedish authorities agree with the staff on the need for fiscal adjustment. Indeed, the Government intends to present a series of measures to this end both in separate bills in the course of this autumn and in the budget to be presented in January next year. A substantial reduction will be needed in public dissaving in order to eliminate the current account deficit and simultaneously finance rising domestic investments in the long run. However, I would like to point out that in the short run also the business sector is expected to contribute to domestic savings, investments not having gained momentum, and the profit situation showing improvement.

There is no significant divergence of views between my Swedish authorities and the staff about the importance of a firm monetary policy stance. The staff notices that, after the devaluations, domestic interest rates were allowed to decline again when rates abroad fell. Although the nominal rates have remained above those abroad, it is pointed out in the report that they are in real terms less positive than in some other countries.

Although important, real interest rates may be somewhat difficult to interpret. These rates are calculated as nominal rates adjusted for actual price changes, the latter usually considered to reflect price expectations. Actual price changes may, however, sometimes be poor indicators for such expectations. This is in fact likely to be the case for Sweden in the present situation. First of all, the devaluation of the krona inevitably causes a temporary cost-push effect through import prices, affecting actual prices but not necessarily price expectations. Second, prices have increased this year due to reduced indirect subsidies and higher indirect taxes, measures that should facilitate monetary stability and consequently lead to lower price expectations. Despite these special circumstances affecting prices, the real long-term rate in Sweden is now as high as about 5 percent. This is historically a high rate, even by international standards, and it is in line with real rates in most other countries.

Extending his remarks, Mr. Lindå noted that on page 12 of SM/83/170, the staff had said that Sweden's official development assistance (ODA) was projected to run at 0.85-0.9 percent of GNP over the next few years. In fact, the Swedish authorities had not made any such official projections.

Mr. Schneider observed that, after several years of consecutive deficits on current account and in the central government budget, together with other imbalances in the economy, the Swedish authorities had succeeded in improving the situation by adopting new economic policies. The adjustment strategy had consisted of depreciating the krona as required to maintain or regain competitiveness in the export sector, while simultaneously adopting measures in public finance, investment, and incomes policies to correct the effects of labor market measures on employment. The authorities' strategy had differed from what could be considered normal practice in most other industrial countries, especially with respect to inflation, in that they had applied an unusually active incomes policy. For that reason, and against a background of incipient economic recovery worldwide, the trends for Sweden in 1983 for economic growth, external balances, and wage and subsidy policies appeared to be favorable. However, the goals set by the authorities on restructuring the economy were flawed because they entailed accepting substantial deficits both in the central budget and on current account.

Following two years of negative growth, Sweden's GDP in 1983 was expected to grow by 1.8 percent in real terms, Mr. Schneider noted. The turnaround was attributable mainly to the combined effects of the exchange rate adjustments of 1981 and 1982 and their impact on foreign balances, along with increased capacity utilization and gains in productivity. However, despite increased average profit margins in the economy, the recovery in investment had been extremely slow, and there had been a decline in fixed investments since 1980. Traditionally low rates of capacity utilization in the Swedish economy gave the authorities ample room for maneuver in using suitable policies to increase output; by contrast, in the longer run, restructuring the economy and maintaining low unemployment would depend on new investment. The low rate of domestic savings would make it extremely difficult for the authorities to increase domestic investment and eliminate the negative effects of rising investment on the current account position.

The size of the central budget deficit was the key issue for economic policy action in the medium term, Mr. Schneider considered. He had been especially concerned about the medium-term forecasts of budget trends given in Section III of SM/83/189, according to which the central government deficit would remain at about 13 percent of GDP in the absence of additional measures. Various automatic mechanisms left the authorities little room for maneuver in reducing the central budget deficit, affecting as they did about 85 percent of central government spending, including interest on the debt, industrial subsidies, and indexation on several items. The external debt burden, the authorities' belief in the difficulty of further increasing overall taxation, and the likelihood that more restrictive fiscal measures would produce undesirable and counterproductive results would call for carefully designed fiscal policies in the medium term. He welcomed the authorities' intention to modify the indexation of most transfer payments and to reduce the level of public dissaving.

Following the larger than expected increase in the money supply during 1981 and 1982, the Government had attempted to finance part of the budget deficit by issuing short-term treasury bills, which allowed some limitation of the increase in monetary aggregates, Mr. Schneider noted. He agreed with the staff that the authorities were concerned about how the treasury bills--equal to 10 percent of the money supply by the end of 1982--would be rolled over at maturity. Perhaps the staff or Mr. Lindå could provide more information on the possibility of issuing special medium-term and long-term treasury bills in order to avoid potential difficulties arising from the maturity of short-term bills.

The remarks made by Mr. Lindå on interest rate policy were valuable, especially the discussion of how to interpret real interest rates, Mr. Schneider continued. From a theoretical point of view, it would be desirable to base the calculation of real interest rates on expected prices rather than on actual prices. However, such a procedure would entail a number of conceptual difficulties. Therefore, in general, comparisons among countries were being made by adjusting nominal exchange rates to reflect actual price changes. Would it really be possible to calculate and compare real interest rates mainly on the basis of inflation rates expected for industrial countries? How would that calculation method help the interpretation and analysis of economic policies? In Sweden, were real interest rates--calculated on the basis of lower price expectations--more positive than real interest rates calculated for other countries using expected inflation rates?

Finally, the Swedish authorities were to be commended for making such a high percentage of their GNP available for official development assistance, Mr. Schneider remarked.

Mr. Erb expressed general agreement with the staff papers. At the time of the Board discussion of the October 1982 devaluation of the krona (EBM/82/133, 10/8/82), he had said that it was important for the Swedish authorities to support the devaluation with suitable financial policies so that the gain in competitiveness would not be inflated away. He had also stated that the increase in profitability resulting from the devaluation provided further good justification for the authorities to reduce industrial support so that Sweden's industrial structure could be rationalized.

The authorities did appear to have attempted to support the devaluation through a more restrictive monetary policy, but a still firmer monetary policy was needed, Mr. Erb continued. In that connection, the fiscal deficit took on a special importance. The fiscal deficit was quite large as a percentage of GDP, and the authorities would have to reduce the deficit if they were to restrain monetary growth in order to achieve the ambitious inflation targets and reduce the current account deficit. Therefore, he supported the staff view that the authorities would have to take further action in order to contain the large fiscal deficits.

The authorities were taking some steps in the right direction by planning to cut back industrial support significantly under the 1983/84 budget, and he urged them to meet their goals fully, Mr. Erb remarked. In his view, there had been room for cutting back industrial support in fiscal year 1982/83, the devaluation of the krona having taken place in the first trimester of that fiscal year. Clearly, the authorities would have to take other steps to reduce the fiscal deficit, since industrial support had accounted for only 2 percentage points of the fiscal deficit as a percentage of GDP at a time when the entire central government deficit had equaled 14 percent of GDP. The authorities would have to be more aggressive in their restraint if they were to reduce the budget deficit significantly.

In regard to wage developments, the authorities and labor were to be commended for following a reasonable course since the October 1982 devaluation, Mr. Erb said. Continued restraint would be required if the authorities were to achieve the inflation goal of 4 percent in 1984 and thereby contribute to maintaining Sweden's competitiveness.

Like the staff, he believed that the exchange rate policy would be more appropriate if it were supported by a significant reduction in industrial subsidies and by the adoption of a firm fiscal policy stance, Mr. Erb concluded. It was disappointing that the authorities had not taken more decisive action on monetary and fiscal policy or moved toward eliminating industrial subsidies at the time of the 1982 devaluation. He encouraged them to move rapidly in those areas in the coming year.

Mr. Lovato said that he agreed with the thrust of the staff report. The Swedish economy had been responding positively to the maxidevaluation of the krona in 1982, and the authorities had supplemented the exchange rate action by adopting a broadly appropriate set of policies. However, the authorities must exercise extreme caution lest the positive trend under way be reversed.

The authorities intended to reorient the industrial base and bring down inflation, without sacrificing the essential objective of full employment or at least with minimum consequences on people's living standards. In that respect, Sweden, with its long tradition of cooperation between social partners, clearly enjoyed a comparative advantage. Like the staff, he was pleased that wage agreements for 1983 were indeed consistent with the restraint in income growth and restoration of profitability. The staff seemed worried that the authorities' prudent attitude might be reversed in 1984, but the positive features included in the agreements reached during 1982--such as the reduction of reliance on indexation to past inflation rates and to other groups in the labor force--seemed to augur well for continuation of those policies in the year to come. He did agree with the staff that the authorities ought to follow determined financial policies designed to make the inflation target credible and thereby help to keep wage settlements reasonable.

The main divergence in opinion between the Swedish authorities and the Fund staff occurred in the fiscal field, Mr. Lovato remarked. There appeared to be a philosophical difference between them on the rôle of government in an economy, particularly on the appropriate degree of income redistribution to be achieved through action from the center. He agreed with the staff on the need to increase domestic savings if Sweden's current account deficit was to be reduced to zero while investment grew. Even though the gross domestic savings ratio in 1982/83 had grown instead of shrunk, reversing the declining trend that had previously prevailed, the relatively large budget deficit seemed to be consistent with the needed rebound in investment, particularly because the investment component of public expenditure was minimal. He was therefore glad to hear of the authorities' intention to stick to their budget estimates, even though specific plans had not yet been formulated. Could the staff or Mr. Lindå say whether any more definite information was available, particularly about the planned modification in the indexation of transfer payments?

The Swedish people were in the midst of rethinking the role of their Government, as shown by the authorities' intention to reduce marginal indexation to a maximum of 50 percent, Mr. Lovato said. Policies should be judged against that background, rather than against a yardstick of short-run stabilization.

He shared the staff's apprehension about excessive liquidity in the economy and could also appreciate the steps undertaken to reduce monetization of the fiscal deficit, Mr. Lovato continued. He had been left unimpressed by the staff's argument in favor of higher interest rates, based on a comparison with real interest rates in other countries, not only because such comparisons appeared meaningless, but also because excessive dogmatism on the matter might encourage the authorities to undertake measures detrimental to the increase in investment that the staff recognized was needed.

As he had said nine months previously, Sweden had acquired a comparative edge in its external position owing to the devaluation, Mr. Lovato noted. Should downward pressures on the krona materialize in the future, the authorities would be well advised to defend the current parity before resorting to another devaluation, which, besides undermining the anti-inflationary effort, would deliver another serious blow to economic cooperation in Scandinavia and in the world.

Mr. Grosche expressed agreement with the staff appraisal. In his view, the objectives of the large devaluation the previous October had been, first, to improve Sweden's competitiveness, and second, to enable the authorities to delay making a strong adjustment in their financial policies, in contrast with the stance assumed in other European countries. The improvement in competitiveness had helped to bring about a strong rise in exports and profit margins. However, he agreed with the staff that financial restraint and continued wage moderation would be required before the desired restructuring of the economy could come about. Without firm adjustment measures, the benefits from the krona devaluation could be dissipated in a new round of inflation, and Sweden could again quickly approach conditions in which further devaluations became necessary. To avoid any round of devaluations, with adverse consequences for other countries, the authorities had to put much greater emphasis on budgetary restraint. He regretted that, despite several attempts, they had been unable to reverse the trend and to cut expenditures, reduce deficits, and slow the fast-rising national and external debt. After all, public spending had reached 70 percent of GDP. The figure had to be scaled down to enlarge the scope for private activity. Given the high level of taxes, he agreed with the staff that restraint had to be concentrated on expenditure, particularly on transfer payments. He strongly urged the authorities to implement their intention to curtail industrial subsidies drastically in the 1983/84 budget. In the Chairman's summing up at the special consultation held the previous December (EBM/82/166, 12/22/82), the Chairman had expressed the wish of the Executive Board that the Swedish authorities should dismantle industrial and export subsidies as expeditiously as possible. Was Mr. Lindå in a position to provide Directors with further information about the phasing out of those subsidies?

He found it worrisome to read, on page 6 of SM/83/170, that almost 85 percent of central government spending was determined by automatic mechanisms, such as indexation to wage and price changes, Mr. Grosche said. Clearly, the planned modification in the indexation of transfer payments would be crucial to reduce the growth of expenditure. Monetary policy should not accommodate but rather should actively moderate inflationary trends, if the authorities were to achieve their ambitious target of a price increase of only 5 percent in 1984. He shared the staff view that greater interest rate flexibility was necessary. There was a tendency toward capital outflow, partly because real interest rates in Sweden were below the rates in some other countries. He also wondered, given the authorities' policy stance, whether the markets expected future interest rates to be so low that present nominal rates could be considered more or less correct. Perhaps a firmer monetary policy could be supported by the adoption of monetary growth targets, thus enabling the Riksbank to be less accommodating when financing the Government's budget inside the banking system. He welcomed the authorities' intention to allow upward pressure on the krona to be reflected in a movement of the exchange rate, rather than in a relaxation of domestic financial policies.

The Government's plans to introduce profit sharing in the form of wage earners' funds had reportedly generated a debate in Sweden, Mr. Grosche continued. Critical comments had been made by representatives of enterprises who feared interference with their decision making. However, he believed that such a scheme, solidly constructed, might help to bring about the higher profits needed for investments, and might strengthen the social consensus.

In conclusion, although the outlook for Sweden's economy seemed brighter than its present position, he was somewhat skeptical about the medium-term restructuring of the economy, Mr. Grosche said. He had not become any more optimistic on reading on page 36 of SM/83/189 that the Government had reversed two steps taken by its predecessor to economize on public expenditure on social benefits.

Mr. Suraisry expressed general agreement with the staff's analysis and conclusions. The Swedish economy faced a number of deep-rooted problems. The pursuit of expansionary fiscal policies since the mid-1970s had led to a rapid increase in public expenditure, a growing debt burden, and sizable deficits in the fiscal and external accounts. Manufacturing output had declined, inflation remained high, and domestic savings--public and private--had fallen sharply as a percentage of GDP. Attempts by the authorities to correct those imbalances had so far been unsuccessful. There had, however, been some encouraging developments in recent months. The devaluation of the krona in October 1982, combined with moderate settlements in the 1983 wage round and a marked improvement in productivity, had considerably strengthened the profitability and the competitive position of Swedish industry. Exports had grown strongly, and the current account deficit would be significantly reduced in 1983. Sweden was well placed to benefit from the expected world recovery, and further improvement in the current account was likely in 1984.

The short-term outlook was therefore more favorable than for some time past, Mr. Suraisry noted. The central question was whether the authorities would use their opportunities to tackle the underlying problems and to lay the basis for sustained growth over the medium term. The task would not be easy, but it was important to begin immediately, since delay would only exacerbate Sweden's problems. The objectives that the authorities had set for themselves--curbing inflation, reducing the external debt burden, and raising domestic savings to finance restructuring--were ambitious and commendable, as the staff had said. However, firm financial policies would have to be adopted as soon as possible and sustained for some time to come.

Public expenditure had risen to 70 percent of GDP, and the central government deficit had risen to 14 percent of GDP, Mr. Suraisry noted. Unless those trends were reversed over time, it would be difficult to avoid excessive liquidity creation, high inflation, and crowding out of private investment. The authorities recognized that the 1982 income tax reforms and the measures taken to reduce expenditure in the current fiscal year were important steps in the right direction. He particularly welcomed the authorities' intention to eliminate indexation of most social transfer payments by early 1984 and to reduce support for ailing industries. Those potentially far-reaching changes were essential if the budget deficit was to fall below 12.5 percent of GDP in 1983, as planned, and if the decline was to continue in future years.

He welcomed the importance attached by the authorities to stricter monetary policies, Mr. Suraisry remarked. He hoped that they would continue their efforts to finance an increasing share of the budget deficit by nonmonetary means, particularly as those efforts had already contributed to a marked slowdown in the growth of bank credit in broad money since mid-1982. Continued wage restraint was also essential for the success of the authorities' strategy. It was therefore encouraging that the social partners had accepted a reduction in real wages as a necessary concomitant of the October devaluation. The absence of indexation clauses or earnings guarantees in the 1983 settlements was another positive sign, for it had helped to keep unit labor costs down and had improved profit margins in industry. He shared the staff's concern, though, that the recent higher settlement for white-collar workers could have a demonstration effect on the 1984 wage round. It was therefore vital that the authorities should make the 4 percent inflation target credible through appropriate demand management measures.

In the longer term, he would encourage the authorities to press ahead with the necessary structural adjustments in the industrial sector, Mr. Suraisry said. The recent measures taken to rationalize shipbuilding were welcome, and he fully supported the policy of linking official assistance to capacity reductions, notably in the iron and steel industries. As his chair had said before, the authorities of other industrial countries should keep in mind the principle of comparative advantage when deciding whether to assist faltering industries or whether to shift resources to new areas with greater potential for growth and increases in productivity.

Finally, the authorities were to be commended for maintaining an open trading system and for their firm stand against protectionist tendencies in the GATT framework, Mr. Suraisry concluded. He also commended them for their good record in providing ODA and hoped that they would adhere to their plans for keeping ODA as a percentage of GDP above the UN target for the next few years.

Mr. Blandin recalled that his chair had already made use of the opportunity provided by the special Article IV consultation with Sweden in December 1982 to express its views on the authorities' economic management.

The exchange rate action taken by the authorities the previous October had produced largely beneficial results, which had contributed to improving the outlook for the Swedish economy. The question now was whether the present policy orientation would provide the necessary framework for continuation of the favorable trend that had begun in 1982.

From a short-term perspective, the improvement in productivity, competitiveness, and profitability of the business sector had been particularly marked, Mr. Blandin continued. As a result, exports had been growing at a rate sufficient to bring about significant gains in Sweden's market shares abroad, while imports into the country had been held in check. Thanks largely to wage moderation and a temporary price freeze, inflationary pressures had been lower than some might have feared. Finally, international confidence, as evidenced by capital movements, had strengthened notably. However, the authorities' main goal appeared to be more ambitious: they wished to bring about a significant restructuring of the economy so as to create the conditions for a sustained pattern of growth that the present structure, described only recently as a model for the world, no longer seemed able to provide.

He agreed with the staff view that fiscal and monetary restraint and wage moderation were the keys to further progress, Mr. Blandin remarked. Restraint would not come easily in a country long accustomed to enjoying steady prosperity and social progress, but adjustment was clearly in order.

The staff report underlined the recent strong improvement in Sweden's relative unit labor costs, largely as a result of past devaluations, Mr. Blandin noted. He would be interested in knowing a little more about the relationship that might exist between the competitive position of Sweden and the restructuring of its industry. One possibility would be to let market forces dictate future changes, with results perhaps largely unpredictable at present. Another possibility, more likely in a country such as Sweden with a well-established tradition of intelligent interventionism, would be to provide for an orderly transfer of resources away from the least promising sectors. He would appreciate it if Mr. Lindå could describe his authorities' strategy and ideas on restructuring.

The rate of unemployment in Sweden was almost as low as rates encountered in countries that tended to be regarded as examples of successful management, such as Japan and Switzerland, Mr. Blandin said. Nevertheless, he wondered whether the figures were really comparable between countries whose economic systems were so different. In Sweden, where public sector spending accounted for 70 percent of GDP and where transfers from the state to business were sizable, he suspected that the official employment figures had been somewhat enhanced by jobs and occupations of less than fully convincing economic usefulness. Again, he would appreciate Mr. Lindå's or the staff's opinion about the possible phenomenon of hidden unemployment, and about the consequences on future unemployment rates of the policy of structural adjustment upon which the authorities had embarked.

Mr. Wicks expressed agreement with the staff appraisal. In particular, he supported the staff's indication of the need for structural change in the Swedish economy. Devaluation alone was insufficient to achieve a restructuring of the economy, which had to include a transfer of resources to the productive sector. The devaluation of the previous October had provided a breathing space to achieve the necessary structural change. Unless the present serious fiscal and current account external deficits were tackled, the long-term aims of the Swedish authorities of achieving lower inflation, a recovery in investment, and a restoration of competitiveness would be jeopardized.

The Swedish authorities' intention to reduce the budget deficit in relation to GDP in the next two years was commendable, Mr. Wicks considered. He certainly agreed that further overshooting of expenditure targets and budget deficits should be avoided, and also that the present plans for reducing spending ought to be regarded as a minimum target. In particular, the authorities should press ahead with legislation limiting the indexation of transfer payments and the automatic adjustment of pensions; legislation should also be carried through for the implementation of tax reforms. He especially welcomed the authorities' plans to reduce spending on industrial subsidies, a crucial part of the economic restructuring, and he hoped that the Government could muster sufficient political and social backing to implement the reductions. Indeed, it was doubtful whether such industrial subsidies could be justified any longer in view of the substantial improvement in Sweden's competitiveness brought about by the devaluation of the krona. Regrettably, recent increases in certain social benefits and outlays on labor market measures might delay fiscal adjustment.

On wages, Sweden had long enjoyed a commendable system of achieving social consensus, and had indeed demonstrated admirable restraint during the previous year or so, Mr. Wicks continued. Did Mr. Lindå think that there might be some risk of a catching up of wages in 1984 and later, as corporate profitability improved? The question was of interest to the U.K. authorities.

On monetary policy, he endorsed the staff's recommendation for a firmer monetary stance in support of the official inflation target, Mr. Wicks remarked. Recently, monetary policy had been somewhat too accommodating, and the excessive liquidity associated with the monetary financing of the growing budget deficit had resulted in large capital outflows. He was also concerned that the authorities were still only beginning to stimulate nonmonetary financing of budget deficits. Could the staff or Mr. Lindå explain how the authorities viewed the progress achieved so far or give any hints of future developments?

On interest rates, he had noted Mr. Schneider's questions about the measurement of real interest rates, Mr. Wicks said. Could Mr. Lindå or the staff say whether interest rate policy was likely to be rendered more effective by the limitation of the deductibility of interest payments against tax, a measure that formed part of the tax reform?

On external policies, he endorsed the support expressed by the staff for the authorities' flexible but asymmetric exchange policy, Mr. Wicks remarked. While agreeing that the level of foreign debt exerted little immediate constraint, he emphasized that in 1983 almost the entire current account deficit of Sweden could be attributed to net interest payments abroad. On the assumption that Sweden would not be a long-run importer of capital, he considered the objective mentioned by Mr. Lindå of attaining a balanced current account position to be a suitable one. Because of the general deficiency in Sweden's current account position, he was somewhat disturbed to see that Table 3 in SM/83/170 suggested that the debt service ratio would rise substantially in 1986, with few prospects for an early reduction. Such a future constraint on policy was an added reason for the authorities to take early action to reduce the current account deficit. Thus, he supported the staff view that a sustained improvement in Sweden's current account and debt position would require domestic policies that were no more expansionary than those of other countries.

In short, there were some hopeful signs in Sweden, such as the improvement in corporate profitability and the moderation in labor costs, Mr. Wicks concluded. Nevertheless, an accumulation of previous imbalances had created problems that would take some time to rectify. The Swedish authorities had made a good start but still had some distance to go.

Mr. Schuijer remarked that, like other speakers, he could fully support the staff appraisal. First, the necessity of budget restraint had been rightly stressed. Even though public expenditure had risen to 70 percent of GNP and public sector debt to 61 percent, the authorities' fiscal policy had remained expansionary: according to the OECD, the budgetary impulse had been 1.5 percent of GNP in 1982 and would be the same in 1983. The share of interest payments in public expenditure had risen to 17 percent, a development accelerated by the recent devaluation of the krona. It was indeed desirable that the expenditure target of 4 percent for noninterest items be strictly adhered to, however, on the basis of the measures announced so far, it seemed uncertain that the target could be achieved. The Governor of the Riksbank had recently expressed concern that the envisaged decline of the deficit to about 12 percent of GNP would not come about.

While Sweden's policies had resulted in a moderate rate of unemployment, the low rate masked substantial sectoral shifts in employment, Mr. Schuijer continued. Since 1979, employment had increased by 11.5 percent in the public sector but had declined by 11.5 percent in industry and mining. Another result of the authorities' policy had been a rigid labor market that might prove to be a serious stumbling block for the economic recovery. He wondered to what extent Sweden had profited by the recent devaluations of the krona. A number of effects that had been positive for Sweden had become manifest: a substantial gain in market shares had increased exports by 7.5 percent, so that the current account deficit had declined to a level roughly equivalent to net interest payments on foreign debt, and he had noted Mr. Wicks's comment on that point.

The recent growth in Sweden's GDP had been entirely attributable to the impulse from the devaluation, and inflation had increased only marginally, Mr. Schuijer commented. In general, however, the devaluation appeared to have contributed little to the restructuring of the economy. The major beneficiaries appeared to have been the traditional industries of shipping, wood, and paper, for which government support had not been curtailed. When the Executive Board had discussed the 1982 devaluation of the krona under the special Article IV consultation, Directors had observed that the devaluation alone would not address Sweden's fundamental problems and that supportive domestic measures were needed as well; the abolition of government-supported industries had been one of the particular points stressed. At that time, the Swedish authorities had created the impression that the question of industrial subsidies would be dealt with promptly. It was therefore not an encouraging sign that the sectors with the highest increases in export volume continued to be subsidized.

In conclusion, a firmer monetary stance would have to be adopted in order to attain the inflation target and prevent a possible acceleration of wage increases, Mr. Schuijer remarked. He therefore supported the policy envisaged to prevent any further depreciation of the krona. The intention to allow upward pressure on the krona to be reflected in the exchange rate rather than in a relaxation of domestic financial policies was welcome; he found it indicative of the priority that the authorities were giving to combating inflation.

Mr. Mtei expressed general agreement with the staff analysis of the Swedish economy. Economic activity continued at a low level, with 1982 having been the second consecutive year of contraction in GDP. He was, however, pleased to note that the present forecasts indicated an upturn in the economy for 1983, although the projected growth rate of 1.8 percent was far below the figure recorded four years previously. At the same time, the inflation rate in Sweden remained high and compared less than favorably with the rate in other industrial countries; the divergence in inflation rates had been one of the principal reasons for the decline in Sweden's external competitiveness. Moreover, the marked disequilibrium between domestic savings and domestic investment explained Sweden's growing dependence on foreign capital.

The imbalances in the Swedish economy appeared to be rooted in the rapid increase in government spending, which had resulted in large budget deficits, Mr. Mtei recalled. Against that background, he welcomed the information provided by Mr. Lindå that the authorities were aware that the present fiscal situation was untenable and that they intended to take corrective action during 1983 and in the budget to be presented in January 1984. He also welcomed the authorities' intention to eliminate the indexation of most transfer payments from 1984 and to deal with public sector dissaving.

The emphasis on reducing inflation was welcome, but success would depend on the progress made in implementing policies of fiscal restraint, Mr. Mtei continued. A major advantage to be derived from curbing inflation was the potential for improving the competitiveness of Sweden, which in turn would help to improve the current account of the balance of payments. Progress in reducing inflation should also stimulate a recovery in domestic investment. However, the achievement of the inflation target would require moderate wage increases in the coming year; the authorities believed that the inflation target could be achieved in 1984, provided that wage costs did not rise by more than 6 percent. The absence of index clauses in new wage agreements in 1983 was a step in the right direction.

The expansion of domestic credit had reflected the weakness in the budgetary position, Mr. Mtei noted. However, in the recent past the authorities had increased their efforts to finance a larger share of the budget deficit outside the banking system. Although such an approach might be appropriate from the standpoint of reducing inflation or attaining equilibrium in the balance of payments, the authorities should nevertheless remain concerned about diverting financial resources to the public sector that could otherwise be used for investment by the private sector.

The recent devaluation of the krona had helped to strengthen Sweden's competitive position, Mr. Mtei said. Together with the recovery in the international economy, the devaluation should improve profit margins in industry. Subsidies to industries should therefore become less necessary, since they in effect tended to prevent or weaken structural change. He welcomed the assertion in SM/83/170 that the Swedish authorities supported free trade. He had been concerned, however, that the trading system discriminated somewhat with respect to agricultural products, footwear, and textiles, products for which developing countries appeared to have a comparative advantage.

His chair wished to compliment the Swedish authorities for having maintained a record in providing official development assistance that was worth emulating by other Development Assistance Committee members, in spite of the strains on the Swedish economy in the recent past, Mr. Mtei continued. It was noteworthy that most of the assistance was given in the form of grants, with priority accorded to low-income developing countries and to agricultural and rural development.

Mr. Teijeiro commented that the basic issue in the Swedish economy was macroeconomic policy design. The experience of the past decade showed that the authorities were pursuing an objective of fixing the price of all relevant variables: incomes policy was designed to yield a particular wage level, the exchange market had fixed the rate of the krona, and the capital market had fixed interest rates. Government intervention then resulted in fixing a set of crucial relative prices, such as the return on capital vis-à-vis the return on labor or the level of wages in terms of traded goods. It might occur that the set of relative prices, so determined, was not the equilibrium one. In Sweden, the disequilibrium showed up in the degree of foreign indebtedness. Table 23 on page 63 of SM/83/189 indicated that foreign indebtedness had been designed to compensate for the deficit on current account. The disequilibrium that had arisen in the late 1970s had promoted changes in the right direction in exchange rate policy.

During the special Article IV consultation held in December 1982, Executive Directors had expressed many subjective opinions about the appropriateness of the krona devaluation and its magnitude, Mr. Teijeiro recalled. What were the relevant criteria for judging whether the devaluation had been excessive or insufficient? His impression was that the crucial element for making such a judgment was the fact that Sweden's foreign indebtedness continued to be not a genuine inflow of capital attracted by the private sector, but rather an artificial process determined by government decision. There could be no doubt that, if the Government stopped borrowing abroad and obtained all public sector financing domestically, adjustment would require either higher interest rates, or further depreciation of the krona, or both. To avoid a continuously accumulating disequilibrium in the form of foreign indebtedness, greater flexibility in some of the macroeconomic variables was needed. In principle, the Government could firmly stick to one numeraire, such as the nominal exchange rate; it could not stick to three numeraires at the same time.

One alternative would be to stick firmly to the current nominal exchange rate of the krona, to stop all public foreign borrowing, and to finance the public sector deficits completely in the domestic market, Mr. Teijeiro said. That alternative would imply higher interest rates that would help to maintain the gain in competitiveness recently achieved by Sweden, and in the medium term should increase its competitiveness. The cost of that alternative would be higher unemployment, arising from the short-run inflexibility of nominal wages and public sector expenditure. The advantage of the first alternative lay on the inflationary front; to reduce the cost of inflation in terms of unemployment would require greater flexibility in incomes policy and public sector expenditure.

A second way to construct a policy that avoided further external disequilibrium would be to allow for a more flexible exchange rate policy, Mr. Teijeiro continued. Incomes policy appeared to be a deeply entrenched political element. Thus, the best exchange rate policy might be one that allowed for more flexible exchange rate management aimed at achieving balance of payments equilibrium without government external borrowing. The devaluation of the krona in 1982 had been a movement in the right direction, and he commended the authorities for their efforts to contain wages and public sector expenditure. However, he agreed with other Directors that the size of public sector spending and deficits was still inconsistent with a return to a more balanced economy. The authorities had sought to delay adjustment by borrowing abroad, but they could not avoid the consequences much longer.

Under both of the alternatives that he had mentioned, a decisive adjustment of the public sector deficit and spending was an essential element in avoiding either higher inflation or higher unemployment, Mr. Teijeiro concluded. The Swedish authorities deserved praise for having chosen to make a decisive adjustment. He encouraged them to pursue the reconsideration of the role of the public sector that seemed to be under way at present.

Mr. Nair expressed agreement with the staff appraisal and his appreciation for the foreign aid policy of Sweden. First, the volume of foreign aid was not treated as a residual item, subject to change at the first sign of domestic difficulties; rather, it was viewed as an element that ought to be maintained despite such problems. Second, Sweden had for some years been maintaining ODA at a rate above the accepted UN target, and the country's commitment to maintaining ODA at high levels during the next few years would enable recipient countries to plan with some certainty. The quality and direction of Sweden's ODA were also highly suitable to developing countries and deserved commendation.

Mr. Casey remarked that, as other Directors had noted, Sweden had for some years followed inappropriate financial policies and had become trapped in what had been called the "revolution of entitlements." There had been several recent improvements in wages and indexation, but it still seemed too early to say whether the economy had turned the corner. Regrettably, some aspects of fiscal policy for 1983/84 sounded like business as usual, particularly the proposed increase in social welfare transfers. He shared the concerns of Mr. Schneider and other Directors about the medium-term fiscal projections.

An economist had once said, "The ultimate aim of economic activity is the nirvana of economic passivity," Mr. Casey continued. Fortunately, for most countries, the prediction was wrong: economic activity in fact bred more economic activity, not less. By contrast, the prediction did seem to have some applicability to Sweden, whose economy had been in a state of passivity for some time. Eighty-two percent of GDP was consumed, public sector spending accounted for 70 percent of GDP, and 80 percent of public spending was termed "uncontrollable." Industrial output had fallen 6 percent below its peak in 1974, a dramatic figure in light of the low rate of capacity utilization. The tradable sector had been shrinking and clearly required restructuring. Gross external debt had risen to 32 percent of GDP, a high figure for an industrial developed economy. Sweden's gross debt service ratio would rise to 23 percent of GDP by 1986; as Mr. Teijeiro had suggested, the indebtedness might well be a product of disequilibrium prices. Factors of production have been undermined either by excessive taxation or, ironically, by excessive subsidization. Absenteeism, immobility, and high unemployment benefits were continuing to affect the labor market. At least until recently, low profitability had hindered investment and innovation. Income equality and high marginal taxation had damaged risk-taking and entrepreneurship. The rate of return on capital had been so low that in the past an entrepreneur had found it more remunerative to buy treasury bills, a practice that had fostered still more government intervention. Clearly, the so-called bridging policies of the past had worked poorly, crowding out the private sector and the tradable sector.

The emphasis on consumption in Sweden implied a high social rate of discount, Mr. Casey remarked. The community, especially the public sector, had seemed reluctant to save or invest because the future was implicitly discounted at a rather high rate. Consequently, the authorities had the challenging task of convincing the community that the future did matter, but they had to do it by example, especially in the fiscal area. In addition, there had to be a less ambivalent attitude toward profit. In the recent past, for example, the trade unions had had a say in how profits should be used. Moreover, the surtax on company profits paid out as dividends had probably hurt equity participation in companies. While he thought that some progress was being made in dealing with the role of profits, like Mr. Grosche, he was unsure where the review of profit sharing would ultimately lead.

As other Directors had noted, past policies had damaged the economy of Sweden, leading to a sort of neoclassical stationary state, Mr. Casey considered. Past policies had damaged the world economy as well, because Sweden's extensive borrowing abroad to keep up consumption at home could have been used by poorer countries for investment. If he seemed to exaggerate, it was only because he felt strongly about the need for symmetrical adjustment between rich and poor countries, which lay at the heart of the Fund's responsibility for surveillance.

Sweden still had a strong competitive edge, Mr. Casey noted. He was therefore relieved that the authorities were reducing industrial subsidies, and he hoped that the cuts also applied to subsidized export credits. He welcomed the flexible margins, the benchmark, and the intervention aspects of the present asymmetrical exchange rate policy, which had become clearer since the special Article IV consultation with Sweden in December 1982. However, complementary monetary and fiscal policies were also required; interest rate policies should become more flexible, however inflationary expectations were measured.

The staff representative from the European Department, responding to a question raised by Mr. Schneider, Mr. Lovato, and Mr. Wicks, stated that conceptual difficulties existed in measuring real interest rates based on forward-looking expectations. One way of judging the level of Swedish interest rates that included an assessment of inflationary expectations by participants in financial markets was whether interest rates in Sweden were high enough to prevent an outflow of foreign exchange. In the light of the need to pursue a firmer monetary policy designed to achieve the lower inflation target adopted by the authorities, the staff had reached a judgment that greater caution in allowing interest rates to decline in 1983 would have been helpful. In late July, interest rates on special treasury bills had in fact been raised: rates on the 6-month bills had been increased from 11 percent to 11.6 percent and on the 12-month bills from 11.3 percent to 11.9 percent. The Swedish authorities had also attempted to lengthen the maturity of special treasury bills by introducing an 18-month bill. They also planned to tap household savings more directly in 1984, principally through longer-term deposits. The real test of the interest rate policy would come when private investment recovered and the net financial balance of the enterprise sector weakened. Ultimately, flexibility would be required in interest rates, and also in the bond market, in order to ensure sufficient nonbank financing of the budget deficit.

On fiscal policy, the staff representative recalled that Mr. Lovato had asked whether the staff had anything more definite to say on the fiscal measures to be introduced later in 1983. The Swedish authorities were aware of the need for fiscal adjustment, and the medium-term fiscal estimates were meant to demonstrate that need. Details of the planned measures to be taken later in the year were unknown to the staff at present. The envisaged modifications in the indexation of most social transfer payments would be important as a part of the effort to dampen inflationary expectations before the next wage round.

A question about how the Swedish strategy was supposed to work had been asked by Mr. Blandin, the staff representative recalled. The Swedish authorities themselves called their approach to economic management "liberalistic," which meant that market forces were permitted to work their way through the economy, the idea being that the recent improvement in competitiveness should strengthen the manufacturing sector. The planned reduction in industrial subsidies should help structural adjustment. For the strategy to be successful in the longer run, the authorities needed to release resources from the public sector to the private sector by reducing public spending.

If hidden unemployment were added to the official figures, including particularly the labor market measures taken over time that had boosted employment in local governments, unemployment would total about 7.5 percent of the labor force, the staff representative from the European Department estimated. The labor market measures, while reducing open unemployment, might also have reduced labor mobility. What would be important for the future was that labor should be released from the public sector once the private sector recovered.

Mr. Lindå recalled that Mr. Erb, Mr. Schneider, and others had expressed concern with the budget policy of the Swedish authorities. The authorities agreed with the staff on the need for fiscal adjustment. Indeed, the Government intended to present a series of measures to that end.

The new Government had taken effective measures on industrial subsidies, as was clear from page 11 in SM/83/170, Mr. Lindå continued. Thus, the allocation for industrial support measures had been reduced to SKr 1.9 billion in 1983/84--a figure equal to only 1 percent of value added in mining and manufacturing in 1982--compared with SKr 12.1 billion in 1982/83. In addition, the Government intended to reduce export credit subsidies further and would like to see an international agreement on the abolition of such subsidies between industrial countries. Sweden appeared to have a good record in that field compared with most other industrial countries.

Regarding the financing of the budget deficit, Mr. Lindå explained that the authorities had recently intensified their efforts to borrow from the household sector by adding new features to premium bonds, which should yield significantly larger amounts. The first such bond issue had been floated only a few days previously. In 1984, a general savings scheme would become effective, replacing the present tax saving system. The general saving scheme would take the form not of bank deposits but rather of deposits directly with the Government Debt Office. There would be an incentive to save because interest on the bonds would be tax free. In addition, he expected special two-year treasury bills to be introduced shortly. Intensified work was being undertaken to prepare means of borrowing outside the financial system.

The risks of a catch up in wages in 1984 had been mentioned by Mr. Wicks, Mr. Lindå noted. He could only give a preliminary answer: no negotiations were yet under way, as the current agreements in the main sectors did not elapse until the turn of the year. Statements from labor unions about coming wage demands had already been printed in the press; they formed part of the traditional game in Sweden and should not be taken at face value. Two specific policy objectives of the Government aimed, apart from their other effects, at dampening wage demands: the reduction of inflation in 1984 to about 4 percent and the introduction of so-called wage earners' funds, which inter alia would imply a centralized system of profit sharing.

A question had also been asked by Mr. Wicks whether a more flexible interest rate policy would be facilitated by the limitation on the deductibility of interest payments against taxable income that had already been agreed in Parliament, Mr. Lindå said. In 1983-85, new tax regulations would gradually come into effect. A lowering of marginal tax rates and a cap on the maximum deductibility for interest paid would lead to higher interest rate sensitivity to both interest received and interest paid. A concrete result of that change had already been noted. Construction and sales of medium-priced and more expensive one-family houses had fallen sharply, as had their prices, a development that had led to a noticeably lower demand for credit in the noncorporate sector.

Concern had been expressed by several Directors that the monetary policy of the Swedish authorities had been too accommodating, Mr. Lindå recalled. Before the devaluation of the krona in autumn 1982, short-term interest rates had been forced up to about 17 percent. The fall in international interest rates at the end of 1982 and the beginning of 1983 had made it possible for the authorities to follow a path toward lower short-term interest rates at home, while long-term interest rates had been lowered only slightly. The reductions had been made in a cautious way, both in magnitude and in timing. From the peak in autumn 1982, short-term interest rates had been permitted to fall to 11-12 percent by the spring of 1983. Meanwhile, the authorities kept close watch on international interest rates, especially short-term U.S. dollar rates. At no time had the spread between krona rates and dollar rates been allowed to narrow too much. In order to secure a comfortable spread, the authorities had kept the internal money market very tight all year by active debt management and open-market operations. The tendency for short-term rates to fall had effectively been counteracted. The easier international interest rates had made it possible for Sweden to acquire a positive yield curve, so that long-term rates were kept above short-term ones. As mentioned, the long-term rates had fallen only slightly. A positive yield curve was a prerequisite for a monetary policy aimed at reducing the liquidity level of the economy.

The Chairman made the following summing up:

Executive Directors noted that the economic strategy of the Swedish authorities had centered on a substantial improvement in international competitiveness by means of a large devaluation in October 1982. Wage settlements in 1983 had been moderate, permitting a considerable improvement in profitability. The strong recovery in exports had also benefited from the international recovery. Directors felt that the Swedish authorities were in a position to reduce industrial subsidies. While regret was expressed that more action had not been taken earlier, Directors welcomed the sharp reduction in industrial subsidies provided for in the 1983/84 budget and strongly urged the Swedish authorities to adhere fully to these plans. Doubts were expressed whether the retention of any industrial and export subsidies was justified.

Directors commended the intention of the Swedish authorities to follow an asymmetric exchange rate policy and, in particular, to allow upward pressures to be reflected in the exchange rate rather than in any premature relaxation of financial policies. It was stressed that exchange rate policy had to be backed up by firm adjustment measures, in particular more decisive action in reducing the budget deficit.

Directors emphasized that the devaluation would not produce and had not in itself produced the desired restructuring of the economy. This would require a determined effort to deal with the remaining problems besetting the economy, including a high underlying rate of inflation and an excessively large budget deficit. Directors therefore welcomed the intention of the Swedish authorities to shift the emphasis of policy to these problems. They noted that the authorities were aiming to bring the rate of inflation down to 4 percent in the course of 1984, an objective that they considered commendable but that would require a determined effort. Directors felt that the main obstacle to a successful restructuring of the Swedish economy lay in the severe imbalance in the public sector finances. A continuation of a central government deficit at over 12 percent of GDP was inconsistent with the authorities' medium-term objective of eliminating the external current account deficit while promoting the revival of investment.

Directors welcomed the authorities' intention to take additional fiscal measures, particularly modifying indexation of public spending, that were required to reduce the budget deficit and restore public sector savings. Further actions would need to center on the expenditure side of the budget, in particular the high level of transfer payments, since the level of taxation was already very high. Directors noted that the budget deficits had severely complicated the task of monetary management by injecting large amounts of liquidity into the economy. They welcomed the effort made to increase nonbank financing of the budget, but noted that the new debt instruments were fairly liquid. While these efforts had been successful so far, it was felt that a continued high share of nonbank financing of the budget could be achieved only with the help of a more flexible interest rate policy. In this context, Directors noted that greater caution in the lowering of interest rates since late 1982 would have been advisable, especially in view of the foreign exchange outflows that had been experienced.

Directors observed that the devaluations of the past few years had been supported by considerable restraint on the part of Swedish wage and salary earners. They noted, however, that the latest settlement with the white-collar workers had shown a slight tendency toward a renewed acceleration that could cause difficulties in the negotiations in 1984. This would put the achievement of the official inflation target in jeopardy. Adequately restrictive financial policies would be required to dampen inflationary expectations.

The increasing level of Sweden's external debt was noted, and it was clear that the debt service situation was becoming a policy constraint and underlined the need for more forceful domestic adjustment policies.

Directors welcomed Sweden's continued commitment to an open and free trading system and commended its record on development assistance.

It is expected that the next Article IV consultation with Sweden will be held on the standard 12-month cycle.

4. FUND LIQUIDITY POSITION AND FINANCING NEEDS

The Executive Directors considered a staff report on the Fund's current and prospective liquidity position and financing needs (EBS/83/170, 8/12/83).

The Treasurer commented that the review of Fund liquidity related not only to the current situation, on which the staff would like to receive the guidance of the Board, but also to the first two years and four months after the increase in quotas under the Seventh General Review and to the financing of the enlarged access policy. Therefore, the review had a bearing on the question of the limits within which the Fund could hope to finance its credit policy.

Mr. Nimatallah observed that EBS/83/170 confirmed earlier projections that the Fund's liquidity would come under pressure in the short term and possibly in the medium term as well. In the short run, the demand for Fund resources was likely to remain heavy. By end-April 1984, the Fund's usable ordinary resources would decline to about SDR 8 billion, the existing lines of credit would be heavily drawn down, and the commitment gap with respect to borrowed resources would rise to about SDR 8 billion. In his judgment, action was urgently needed to strengthen the Fund's liquidity position during the period if the Fund was to continue to perform its role effectively. He therefore fully supported the efforts of the Chairman to secure additional resources and hoped that they would be successful.

In the medium term, the Fund's liquidity was also expected to be under some pressure, Mr. Nimatallah continued. Three scenarios were possible. Under the optimistic one, recovery would become rapid and widespread and the world economy would strengthen considerably, a development that would help adjustment and should reduce possible pressure on the Fund's resources. Of course, individual countries would continue to experience difficulties, but resources available from the increase in Fund quotas and perhaps some limited borrowing should be sufficient. Under the pessimistic scenario, recovery would fail to gather momentum and the debt problems of countries would worsen, developments that would lead to heavy demand on Fund resources. In such an event, the Fund would have to borrow more. However, keeping in mind that quotas should remain the principal source of Fund financing, serious consideration could then be given to bringing forward the Ninth General Review of Quotas. Excessive borrowing was not in the best interests of the Fund in the long run. Borrowing should be kept well within the existing guidelines, which gave the Fund ample leeway.

Under the third scenario, the recovery would be moderate and not sufficiently widespread to strengthen the world economy, Mr. Nimatallah went on. The third scenario was in line with earlier economic projections and appeared the most plausible, so that it would be prudent for the Fund to plan ahead on the basis of that scenario. Thus, adjustment would proceed, but not very smoothly. Calls on Fund resources would then be less than under the pessimistic scenario but greater than under the optimistic one. In such circumstances, there might be sufficient reason to activate the General Arrangements to Borrow (GAB) to cover the possible financing gap of about SDR 10 billion that the Chairman had mentioned previously.

Under such circumstances, an access limit of 125 percent would be manageable and financeable, Mr. Nimatallah concluded. As such, he agreed with the conclusion reached by the Chairman earlier. Therefore, he hoped that Executive Directors would try harder to support the 125 percent limit, which represented a realistic compromise allowing the Fund to maintain a sound financial position and continue to play its role effectively.

Mr. Lovato considered the estimates for financial years 1984-86 to be quite tentative, given the uncertainties of many of the factors upon which they depended. As for the figures presented for December 31, 1983 to April 1984, the projections and underlying assumptions appeared reasonable: if absolute access to Fund resources remained unchanged, the commitment gap with respect to borrowed resources would rise to SDR 6 billion by the end of 1983 and SDR 7.8 billion by the end of April 1984. It was true that, toward the end of 1983, the Fund was scheduled to obtain an increase in resources deriving from quota payments and the enlarged GAB, but it was far from certain that the quota increase payments would be available at the end of the year.

He could accept a commitment gap of a small amount and for a limited time, Mr. Lovato continued. He considered it risky to move away from the principle of avoiding a commitment gap, and it would be wrong, even for the Fund's external image, if it began to consider ordinary and borrowed resources on a disbursement basis. Given the temporary gap and therefore the temporary needs of the Fund, the effort made by management to strive for more resources until 1984 was reasonable. Particularly at present, a banker had to be prudent and cautious. Therefore, the Fund should refrain for the time being from having recourse to the markets, so as to avoid strengthening the tendency of banks to diminish their financing of countries' balance of payments deficits. Instead, he supported the efforts for a borrowing arrangement between the Fund and official entities, particularly with member countries in good balance of payments and reserve positions. Such arrangements would preserve the cooperative nature of the Fund.

Mr. Polak noted that the only major change in the present presentation compared with the previous one was the considerable enlargement of the amount foreseen for the compensatory financing facility, which had risen from about SDR 3.5 billion to SDR 6 billion for the period through April 1984. The calculations were based--and indeed had to be based--on the assumption that access would be maintained in absolute terms for each member country.

On page 15 (EBS/83/170), the staff stated that the results of its calculations were broadly comparable to those indicated in the review of access to Fund resources issued on June 28, 1983, Mr. Polak went on. However, that paper had shown a wide range of results, depending on the assumptions used with respect to access limits, ranging all the way from 102 percent to 150 percent. He had been trying to see what the staff meant by saying that the results in the present paper were broadly comparable to those in the previous paper. The 115 percent column in the first paper resembled the 110 percent column in the present paper. If he was correct, the present paper should be read with the conclusion that the outcome by April 1986 was indeed derived from the relatively modest figure for access in proportion to the new quotas.

He would have found it useful if EBS/83/170 had contained a clear presentation of the statement by the Chairman on August 31 that a limit of 125 percent was manageable and financeable, Mr. Polak remarked. He assumed that the statement was based on the Fund's present liquidity position, although it also had to be based on certain assumptions about borrowing. He could not see exactly how the Chairman's statement could be derived from EBS/83/170, by which he did not in any way intend to say that the statement was incompatible with the paper. It would be useful if the staff could issue a short supplement to EBS/83/170, indicating the precise assumptions on interim borrowing and use of the GAB that had been implicit in the Chairman's statement.

Turning to more technical aspects, Mr. Polak commented that the staff should make a greater effort in subsequent papers on the Fund's liquidity position and financing needs to strive for precision, clarity, and conciseness, both in the tables and in the text. He had found a great improvement in clarity in Appendix Tables 1 and 2, although he did not like the new term "quota ratio" when the staff was trying to measure what he would call the "debt ratio."

Other tables in EBS/83/170 had regrettably not been improved, Mr. Polak considered. Tables 2 and 3 in the text both measured changes in ordinary resources, the only difference between them being that one was expressed on a commitment basis and the other on a disbursement basis. More than half the numbers in the two tables were the same, but the presentation was so different that it took a great deal of work to understand what the differences amounted to. He wondered whether the tables could not be merged into one. Table 3 in the Annex had a footnote that he had been unable to understand, and in some places the text was so unclear as to be hardly intelligible at all. For instance, he had been baffled by the first sentence on page 17, where the staff gave a definition of the Fund's total of "uncommitted usable ordinary resources," as the "uncommitted ordinary usable resources less the amount of the commitment gap." He was sure that the staff had not intended to say what it had written, but it should be able to find better words.

On one of the most important points--the contribution to be made by the GAB--he could not, even with great effort, understand footnote 6 of Table 6 on page 16, Mr. Polak stated. As far as he could see, the first sentence in the footnote said exactly the opposite of the third sentence. The first sentence said that amounts for the present GAB participants in the enlarged GAB covered those considered sufficiently strong and totaled about SDR 15.8 billion. The third sentence said that no adjustment had been made for any of those GAB lines of credit that might not be usable. Which of the two sentences was true?

He was sure that the staff knew the answers to all those questions, Mr. Polak concluded, but it should have enabled Executive Directors to understand the elements of the discussion. In preparing such periodic papers, the staff should pay additional attention to the editorial aspect of the text and tables.

Mr. Wicks said that he wished to focus on an issue to which Mr. Lovato had already referred, namely, the distinction between Fund commitments and Fund disbursements. It was understandable that the staff had a clear preference for covering all the Fund's commitments, the preference being cogently expressed at the end of the paper. However, he wondered whether it was right to make it a fundamental principle that the Fund should avoid a commitment gap. Experience had shown that the Fund could live with a small gap. After all, the Fund's borrowed resources had been moderately overcommitted for the past six months or so, and although the position might be uncomfortable for the Treasurer, the Fund had nevertheless managed to sustain it. In the future, a somewhat bigger gap might be acceptable if there were sufficient prospects of a reflow of funds from repurchases. Of course, it would be imprudent to carry the approach of relying on repayments too far.

A large commitment gap would certainly concern his chair, Mr. Wicks continued. He agreed that the Fund could not operate purely on a disbursement basis, but had to be ready to cope with contingencies at short notice. In particular, the Fund needed a stock of ordinary resources to cope with the demands for reserve tranche purchases. He did wonder, however, whether the objective should be to try to get back to a situation in which the Fund had no commitment gap at all.

In assessing the Fund's liquidity position, he had looked carefully at the level of undisbursed resources, Mr. Wicks noted. The staff figures showed that the Fund still had over SDR 20 billion in undisbursed resources. Those resources seemed unlikely to fall below SDR 14 billion during the rest of 1983, and the projections showed that they would still amount to about SDR 9 billion by the end of April 1984. He had concluded from those figures that both borrowed and ordinary resources should be adequate to cover foreseeable disbursements until the spring of 1984, so that, for the next six months or so, the Fund could continue its planned disbursements without requiring a fresh injection of resources. Nevertheless, there was no escaping the projection that the Fund's present resources would be almost completely committed by the end of 1983. The staff paper clearly showed that the balance of uncommitted ordinary resources was expected to be only just sufficient to cover the commitment gap with respect to borrowed resources.

Having looked at the figures on a commitment basis, he believed that it would be prudent for the Fund to make arrangements for credit forthwith, in advance of any need for drawing it down, Mr. Wicks recommended. While his authorities hesitated to adopt what he would call a pure commitment approach, they certainly would not want to accept a pure disbursement approach either. In short, in assessing the Fund's liquidity position and financing needs, Executive Directors should steer a course somewhere between the two extremes, leaning a little on the side of caution in commitments. In taking such an approach, Directors would benefit from the staff's assessment of the minimum level of uncommitted liquid balances that the Fund actually needed. The paper on financial aspects of enlarged access (EBS/83/133) suggested a minimum for usable resources of SDR 6-8 billion. Perhaps the staff could also estimate the corresponding figure for undisbursed resources.

Taking the projections in the enlarged access paper together with those in the current paper, he belived that a measure of borrowing would be needed over the next year or two, whatever the Fund's policy on access, Mr. Wicks concluded. There would also be some need for supplementary bridging finance, which the Chairman had actively been seeking. In that connection, it had been helpful to hear the Chairman's amplification at the previous meeting of the costings contained in EBS/83/133 and to hear him express confidence about the possibility of financing access of 125 percent of quota. Like Mr. Polak, he would be interested in further information on the precise ways in which that financing could be guaranteed. Obviously, the fuller the estimates of both commitments and disbursements under various enlarged access options that the staff could provide to Executive Directors, the better equipped Directors would be to determine the Fund's financing needs.

Mr. Orleans-Lindsay noted that the information provided by the staff showed that the Fund's liquidity position remained under considerable pressure, which was unlikely to ease by the end of December 1983 when the quota increases came into effect. Furthermore, in view of the uncertainties regarding the inflow of resources, the strain on the Fund's liquidity position might continue through April 1984 and into the period ending April 1986. The staff's revised estimates showed that uncommitted ordinary resources, which had amounted to SDR 10 billion at the end of July 1983, might decline to about SDR 5 billion at the end of April 1984. Thus, the commitment gap that could come about by the end of December 1983 would remain unchanged at about SDR 6 billion but would increase to about SDR 7.8 billion by the end of April 1984, depending on the effective date of the quota increases and the results of the discussions on enlarged access.

Like other Executive Directors, Mr. Orleans-Lindsay went on, he was worried about the rapidly expanding commitment gap and the decline in the Fund's uncommitted ordinary resources. He shared the view that prudent financial management required the Fund to maintain a satisfactory liquidity position. Quotas should continue to be regarded as the primary source of financing for the Fund. For that reason, some Executive Directors had asked that the Eighth General Review of Quotas should result in a substantial increase in the Fund's ordinary resources, having foreseen that there would continue to be a need for Fund financing on a larger scale if members were to be able to carry out balance of payments adjustment programs while pursuing more liberal trade and exchange policies. Current world economic and financial conditions, especially the reduced rate of capital flows, confirmed that several oil exporting and non-oil developing countries, together with a number of the smaller industrial countries, might encounter severe balance of payments difficulties for which Fund assistance would be needed. Staff estimates--although tentative and based on present absolute access limits--showed that the demand for Fund assistance up to April 1984 might reach SDR 8.4 billion, with a larger share of the arrangements being concluded in early 1984. For the two years from April 1984 to April 1986, the potential use of Fund resources had been projected at about SDR 13 billion, which implied a heavy call on the Fund's resources that could not be ignored.

Like all other Executive Directors, he agreed that there was a close link between access limits and the Fund's resource base as well as with the temporary character of Fund financing, Mr. Orleans-Lindsay continued. His position was that members' access limits should be maintained, not reduced. Therefore, the existence of a large potential demand should be acknowledged, for it could not be fully met from the Fund's primary resource base. The Board would have to find the appropriate means to supplement the Fund's ordinary resources; he favored borrowing.

By adopting a suitable approach to supplement its ordinary resources, the Fund could continue to play its recognized role in international adjustment, Mr. Orleans-Lindsay said. He supported both short-term and long-term measures that had to be taken to ensure an inflow of usable ordinary resources and to achieve an appreciable degree of improvement in the Fund's overall liquidity position. First, Executive Directors should urge their authorities to accelerate the legislative process for approving the new quota increases so that they could come into effect as early as possible, and in any event no later than April 1984. Second, discussions and negotiations that had begun for an enlarged GAB and other such arrangements should be accelerated and concluded, with countries providing specific commitments. Third, the major industrial countries, which had promised to provide bridging facilities to the Fund, should be able to indicate at present the status of the proposed facility, especially whether those facilities were medium term or long term, since short-term arrangements under the bridging facilities were not favored. Fourth, as the Eighth General Review of Quotas would result in quota increases that were small relative to the potential needs of members, the Fund had to begin to consider initiating action on the Ninth General Review. Fifth, the Board should seriously consider the early resumption of SDR allocations, which would help a number of member countries to strengthen their reserve positions and thereby reduce some of the pressure on their balance of payments. A new allocation might also help to reduce demand for Fund resources.

Finally, the Fund might continue to engage in borrowing arrangements, preferably from official sources, Mr. Orleans-Lindsay suggested. Recourse to the private markets should be considered as a last resort. As stated by his chair on previous occasions, the Fund should find a way of easing the burden of charges for the least developed members by devising a subsidy scheme.

Mr. Leeahtam expressed full confidence in the staff's estimates showing that the Fund's liquidity was coming under increasing strain, especially as regards borrowed resources. He hoped that the Executive Board could pay more attention to finding a solution to the problem than to doubting the reliability of the estimates and searching for other criteria by which to measure liquidity problems. In view of the slowdown in commercial bank lending worldwide, the liquidity needs and adjustment requirements of member countries implied a greater role for the Fund and thus a greater demand for Fund liquidity. The liquidity problem would weaken the Fund's ability to fulfill that role and could affect its credibility as well. Moreover, as one Executive Director had noted at the Board discussion on access policy (EBM/83/126 and EBM/83/127, 8/31/83) it was not only the Fund's credibility but also the international financial system that was at stake. The solution found the previous April had been to encourage the Fund to negotiate long-term borrowing from official sources. He understood that management had already achieved some success in its endeavor to negotiate such borrowing, and he hoped to hear more good news soon.

The Board should consider seriously the possibility of borrowing from the private market, Mr. Leeahtam recommended. He shared the staff's view, expressed in the April discussion, that the sooner the Fund went into the market the better, because at present it would be in a relatively strong bargaining position. Furthermore, the commitment gap with respect to borrowed resources--which would climb to SDR 7.8 billion by April 1984--probably could not be bridged by borrowing only from official sources. He did not believe that the Fund should have a commitment gap; it should borrow from private sources. Finally, the Fund's liquidity prospects deserved the attention of Governors, and he hoped that the matter would be brought up before the forthcoming meeting of the Interim Committee.

Mr. Kafka observed that the staff's message was clear: unless the Fund borrowed and received the quota increase, it would be in deep trouble. Thus, borrowing was imperative. He was grateful to the Chairman for his efforts to arrange official lines of credit and to those countries that had indicated their potential preparedness to lend. He also wished to reiterate that the Fund should begin to tap private markets.

In conclusion, he subscribed to Mr. Polak's point on the form of the staff paper, Mr. Kafka continued. Although presentation of such a complicated matter was difficult, it could be simplified.

Mr. Hirao noted that the staff paper provided helpful estimates of the use of Fund resources in the near future and gave highly tentative estimates of potential uses of the Fund's resources for the two years ending April 1986. Those estimates appeared broadly reasonable, under the assumption that members' absolute access would remain unchanged. The additional demands on Fund resources would have to be financed. During the course of the Eighth General Review of Quotas, the principle had been reiterated that quotas should remain the primary source of Fund financing. Under that principle, it would be desirable to expedite the Ninth General Review of Quotas. However, since the quota increases under the Eighth Review had not yet come into effect, and since any general review of quotas required a considerable amount of time, it would be difficult, in a practical sense, to meet the estimated demand with resources to be made available through a new quota increase.

The borrowed resources needed to cover the expected demand for Fund resources during the coming period would be sizable, even after allowance was made for usable ordinary resources that were to become available through quota subscriptions, Mr. Hirao said. His authorities had strong reservations about the Fund borrowing from private markets. Thus, the borrowed resources needed should be financed by members to the extent possible, but experience indicated that it would not be easy to borrow such sizable amounts.

It seemed more feasible to use the enlarged General Arrangements to Borrow to meet a part of the Fund's needs, Mr. Hirao said. There were of course relevant conditions that would have to be met in order to activate the GAB, and careful examination would be needed before doing so.

As noted earlier, the estimates of demand for Fund resources were made on the assumption that members' absolute access as a percentage of quota would remain unchanged, Mr. Hirao said. The staff had indicated in an earlier paper on access policy that the need for borrowed resources with an annual access of 125 percent would be greater by about SDR 5 billion than if access were limited to 102 percent of quota. As additional borrowing of SDR 5 billion would impose a significant burden, he hoped that an appropriate agreement on access policy would be reached by the Interim Committee at its forthcoming meeting, with a view to keeping the Fund's operations financeable in the period ahead.

Mr. Mtei remarked that despite the uncertainty involved in the projections of the demand for and supply of Fund resources, the paper had been helpful in illustrating the Fund's liquidity position. However, he had reservations about some of its implications. The present estimates indicated that the Fund could be forced into safeguarding its financial position and thereby ignoring some genuine requests by members. While the need to maintain an adequate liquidity position could not be overemphasized, there might have been an overdramatization of the potential illiquidity of the Fund. He had been relieved to hear the Chairman say on August 31 that enlarged access for members at 125 percent of quota would be financeable. His chair continued to maintain that, if there was a liquidity problem, a reduction in members' access would not be an appropriate solution. Rather, the solution lay on the supply side, not in exercises to limit or reduce demand.

If the Fund was to continue to play its role in the financial system, it would have to have the necessary resources, Mr. Mtei observed. By revealing the rising trend in the commitment gap brought on by the rapid drawdown of uncommitted ordinary resources and the use of existing credit lines, the paper had brought into focus the need for careful and serious consideration of the supply of resources to the Fund. In the short run, the Managing Director should continue his efforts to increase borrowing from industrial countries and from countries in surplus balance of payments positions. The cooperative nature of the Fund indicated that members in surplus should come forward and assist in providing the needed resources. He had been particularly encouraged to hear Mr. Nimatallah announce earlier in the week that Saudi Arabia was prepared to continue making substantial loans to the Fund, provided that developed countries in balance of payments surplus and with strong reserve positions would do the same.

He urged those members to provide the assistance that might be necessary in the interim period before the formal increase in quotas came into effect, and subsequently if the international financial situation did not improve substantially. It would be unfortunate, if not tragic, if the Fund failed to meet the genuine needs of members at a time when serious imbalances were threatening the smooth functioning of the international monetary system. Specifically, in the short run, management might need to hasten the formalities so that credit lines under the enlarged GAB could be activated.

The long-run solution of the Fund's liquidity problem, as mentioned by other Executive Directors, lay in expanding the Fund's own resources through quota subscriptions, Mr. Mtei said. Thus, his chair had called for a substantial increase in quotas during the Eighth Review. Since the results obtained under that review had been inadequate, there was a pressing need for advancing the Ninth Review of Quotas. Besides expanding its own resources, the Fund might have to consider other sources of borrowing, even in the long run, to augment the flow of resources. Although he was concerned about the cost and other implications of borrowing from the private markets, it should not be ruled out as a last resort. The staff had rightly indicated at the bottom of page 17 the need for the Fund to enter into new borrowing arrangements for enlarged access resources at an early date.

In conclusion, the Fund could solve its liquidity problem by augmenting the flow of resources, expanding its own resources, and borrowing more from official entities, Mr. Mtei suggested. Deliberate delays in concluding arrangements with members and undue shortening of program periods could only aggravate the already difficult economic and financial problems of member countries.

Mr. Lindø remarked that the Nordic countries shared the concern expressed in EBS/83/170. In accordance with the projections, the Fund's holdings of ordinary resources might fall so low that it would be unable to make much use of its own resources as a substitute for a possible shortage of borrowed resources. The need for such a substitution would in itself be unfortunate. The Fund should avoid creating such a situation, which would both weaken its reputation and reduce its opportunities for obtaining extraordinary funds in the future. Most of the Fund's lending from the beginning of January 1984 to the end of April 1986 was expected to take place during 1984. Therefore, it was imperative to ensure that the Eighth Quota Review became effective soon. Even so, a commitment gap with respect to borrowed resources was likely to continue growing from the turn of the year 1983/84. Supplementary borrowing from official sources beyond the SDR 6 billion being negotiated at present might therefore become desirable. Furthermore, the estimates underscored the desirability of considering whether to begin the Ninth General Review of Quotas significantly earlier than the five-year period after the most recent increase that was stipulated in the Articles of Agreement.

The difficulties in obtaining more funds from official sources and the possibility that quota payments under the Eighth General Review might be delayed had to be considered in conjunction with the continued heavy financing needs of many members, Mr. Lindø concluded. Even if members' aggregate access to Fund facilities were kept unchanged in nominal terms, supplementary borrowing in private capital markets might become necessary in 1984. In fact, if the Fund did not succeed in obtaining substantial loans from official sources during the current year, it might become necessary to borrow in private capital markets even before the end of 1983. Thus, the Fund's preparedness to borrow had to remain at such a level that the alternative could be resorted to at short notice.

Mr. de Maulde expressed agreement with everything said by Mr. Nimatallah.

Mr. Alhaimus remarked that the estimates had indicated, amid continuing uncertainties, that the Fund would find it prudent to base calculations on an access limit of 125 percent of quota, which was more consistent with projected medium-term needs. No matter what access policies and calculation procedures were followed, the most important conclusion to be drawn from the present and previous reviews was that there was a still-growing commitment gap. That was the most pressing issue, which could be resolved only if major members showed greater flexibility in lending to the Fund.

Mr. Schneider observed that, despite continuing uncertainties regarding assumptions on future developments, the Fund's liquidity position was coming under heavy strain. He agreed with Mr. Nimatallah that a distinction should be drawn between the short-term outlook and the medium-term outlook. In the short term, he felt uneasy about the SDR 6 billion commitment gap, and he agreed with Mr. Nimatallah's assumptions that world recovery would be moderate, so that the Fund would be confronted with substantial demand for its resources in the years to come.

He understood from page 7 of EBS/83/170 that reserve tranche positions would increase to SDR 25 billion and that liquid loan claims would increase to SDR 13 billion by the end of 1983, Mr. Schneider went on. He did not wish to imply that all the reserve tranche positions or claims would be called, but he could assume that a number of national authorities had some concern about how liquid their claims on the Fund really were in view of the present commitment gap and the expected further demand on Fund resources.

In the short term, it seemed reasonable that the Fund should first rely on the speedy conclusion of the Eighth General Review of Quotas by all members, Mr. Schneider recommended. Further borrowing would also be necessary from official sources in order to close the existing commitment gap of SDR 6 billion. Some Executive Directors indicated that they could live with a small and temporary commitment gap. However, he assumed that some national authorities would feel comfortable if the commitment gap could be closed entirely before the Fund undertook to borrow more.

As to the medium-term outlook, he would not exclude--apart from additional borrowing from official sources--a partial activation of the GAB, Mr. Schneider concluded. In an emergency, he would not exclude borrowing from private markets. Moreover, he agreed with Mr. Hirao that it might be useful to advance the Ninth Quota Review.

Mr. Wang commented that the staff paper gave the impression that the Fund's liquidity position was under increased pressure, even if future use of Fund facilities were measured on the basis of reduced access limits. The Chairman's statement to the Board that an access limit of 125 percent of quota was financeable had somewhat alleviated his concern. However, since his chair had always maintained that the need of Fund members for financing in the years ahead would be on the high side, he urged the staff to give more thought to improving the Fund's liquidity position by various means, including an early implementation of the Ninth General Review of Quotas, a new allocation of SDRs, and increased borrowing. Thus, the Fund could better meet the requirements of its member countries and could play its role in the international financial community.

Mr. Joyce expressed gratitude for the latest figures on the Fund's liquidity position and financing needs. It was particularly useful to state clearly which access limits would be in effect when the new quota increase was completed. While the picture presented did not suggest alarm, there was a need for prudence in the conduct of Fund business during the coming months.

He had drawn three conclusions from the staff paper and the discussion, Mr. Joyce said. First, the Fund's current liquidity position clearly demonstrated the great urgency of completing short-term financing arrangements in the near future. Second, it was equally urgent to complete the quota increase and to put into position the enlarged General Arrangements to Borrow as soon as possible. Third, additional financing would be needed in the medium term, but, as the Chairman had pointed out, those additional financing requirements were not extreme and were likely to be met. Above all, those requirements were compatible with a maximum access limit of 125-375 percent of quota, assuming the continued pursuit of prudent lending policies by the Executive Board.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/83/127 (8/31/83) and EBM/83/128 (9/2/83).

5. ZAMBIA - REPRESENTATIVE RATE FOR THE ZAMBIAN KWACHA

The Fund finds, after consultation with the Zambian authorities, that the representative rate for the Zambian kwacha against the U.S. dollar, under Role O-2(b)(i), is the midpoint of the buying and selling rates. The Bank of Zambia will notify the Fund of changes in the rate and advise of any change in the definition of the representative rate for the Zambian kwacha. (EBD/83/224, 8/29/83)

Decision No. 7512-(83/128) G/S, adopted
September 1, 1983

6. ZIMBABWE - 1983 ARTICLE IV CONSULTATION - POSTPONEMENT

The Executive Board notes the request contained in EBD/83/227 (8/30/83). 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 extend the period for completing the 1983 Article IV consultation with Zimbabwe until not later than October 31, 1983.

Decision No. 7513-(83/128), adopted
September 1, 1983

7. AUDIT COMMITTEE, FY 1984 - COMPOSITION

The Executive Board approves the proposal set forth in EBAP/83/222 (8/29/83).

Adopted September 1, 1983

8. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/83/223 (8/30/83) and EBAP/83/224 (8/31/83) and by Advisors to Executive Directors as set forth in EBAP/83/223 (8/30/83) and EBAP/83/224 (8/31/83) is approved.

APPROVED: March 2, 1984

LEO VAN HOUTVEN
Secretary