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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/162

3:00 p.m., November 23, 1983

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	J. K. Orleans-Lindsay, Temporary
	H. G. Schneider
	X. Blandin
	M. Teijeiro
R. D. Erb	
	T. Alhaimus
	N. U. Haque, Temporary
	T. Yamashita
J. E. Ismael	Jaafar A.
R. K. Joyce	L. Leonard
A. Kafka	
G. Laske	G. Grosche
G. Lovato	
R. N. Malhotra	
	S. El-Khouri, Temporary
	E. M. Ainley, Temporary
J. J. Polak	T. de Vries
A. R. G. Prowse	K. G. Morrell
	O. Kabbaj
	E. I. M. Mtei
	E. Portas, Temporary
J. Tvedt	
N. Wicks	T. A. Clark
Zhang Z.	

L. Van Houtven, Secretary
K. S. Friedman, Assistant

Also Present

African Department: R. J. Bhatia, Deputy Director; O. B. Makalou, Deputy Director; N. Abu-zobaa, P. D. Mortimer-Lee, M. C. Niebling. European Department: P. B. de Fontenay, S. M. Thakur, J. S. Van't dack, H. Vittas. Exchange and Trade Relations Department: S. Mookerjee, Deputy Director; J. Hicklin, R. Johnson. Fiscal Affairs Department: G. Blöndal. Legal Department: W. E. Holder, Ph. Lachman, A. O. Liuksila. Research Department: D. Folkerts-Landau. Western Hemisphere Department: S. T. Beza, Associate Director. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: S. R. Abiad, E. A. Ajayi, J. R. N. Almeida, J. Delgadillo, S. El-Khouri, K. A. Hansen, H.-S. Lee, J.-C. Obame, Y. Okubo, I. R. Panday, P. D. Péroz, D. I. S. Shaw. Assistants to Executive Directors: J. Bulloch, M. Camara, M. Eran, G. Ercel, C. Flamant, I. Fridriksson, V. Govindarajan, D. Hammann, C. M. Hull, A. K. Juusela, H. Kobayashi, M. J. Kooymans, G. W. K. Pickering, E. Portas, T. Ramtoolah, M. Rasyid, J. Reddy, A. A. Scholten, S. Sornyanyontr, Wang C. Y., A. Yasseri.

1. AUSTRALIA - 1983 ARTICLE IV CONSULTATION

The Executive Directors continued from the previous meeting (EBM/83/161, 11/23/83) their consideration of the staff report for the 1983 Article IV consultation with Australia (SM/83/219, 10/26/83). They also had before them a report on recent economic developments in Australia (SM/83/225, 11/4/83; and Cor. 1, 11/21/83).

Mr. Polak commented that Australia faced difficult policy choices concerning the budget deficit and the exchange rate. His main concern was that the budget deficit would cause the country's competitive position to deteriorate. The authorities felt that inflation could be kept in check and exports would remain competitive provided that they continued to finance the budget deficit domestically and in a way that did not create excess liquidity. In addition, they assumed that they could continue to rely on the wage accord, which involved full indexation of wages but no increases in real wages. In fact, however, a large volume of capital inflows--the figure that Mr. Prowse had mentioned being even higher than that referred to by the staff--and the crowding out of the private sector had led to the possibility of a recession, if monetary policy was kept tight, or to a sizable expansion of liquidity. Of the available options, an appreciation of the exchange rate seemed to be the one that the authorities accepted, while even the staff considered that it was the second-best solution.

The Australian authorities, Mr. Polak continued, seemed to have adopted an extreme form of the hard currency option: they hoped that, even though the rate of inflation in Australia was higher than the rate in other OECD countries, Australia could permit some appreciation of the exchange rate and remain competitive by containing nominal wages. He doubted whether that option was feasible. Another option--permitting the capital inflows to increase the rate of expansion of liquidity--probably would not work either. He agreed with the staff that attempts to sterilize the inflow had been unsuccessful and, although interest rates might fall in the short run, the rate of inflation would eventually accelerate, leading to a decline in the competitive position. He was worried that, even though the effects of the two options could be reversed only at great cost, Australia was moving in the direction of those solutions. The authorities should not assume that they would be able to repeat the experience of the 1970s, when Australia's 10 percent rate of inflation was acceptable because inflation rates in other countries were of a similar magnitude. The capital inflows could be stemmed by restrictions. Although that solution would crowd out the private sector and push up domestic interest rates, it could be seen as a second- or third-best solution.

Developments on the monetary side, Mr. Polak went on, should be seen in the context of the external debt position. In its scenario the staff had projected a large current account deficit--equivalent to 4.5 percent of GDP--throughout the 1980s and a steadily rising debt service ratio, something that would clearly be undesirable. The continued recourse of the private sector to borrowing abroad apparently was due to the crowding out of that sector in the domestic capital market and had resulted in current account deficits in 1981 and 1982 that had been some 5.5 percentage points larger than the underlying cyclically neutral deficits. The most desirable option--smaller budget deficits and smaller capital inflows--would reduce the budget deficit by 1.0-1.5 percentage points, thereby helping to lower the current account deficit to some 3.0-3.5 percent of GDP and avoiding any increase in the debt service ratio.

The structural budget deficit was excessively large and had been rather optimistically estimated at about half of the actual deficit for 1983/84, Mr. Polak continued. Special attention should be paid to the trend of expenditures. The authorities seemed firmly committed to continuing on the way to a full-fledged welfare state, and the new welfare programs would have their effect on the budget in coming years. The authorities should study the experience of other countries that had taken the same path; it suggested that rapid growth in welfare spending tended to become uncontrollable.

The staff apparently was skeptical about the usefulness of incomes policy in Australia, Mr. Polak commented. However, Australia's long experience with indexation, which had started in 1922, the likely recovery in 1984, and the strength of the unions suggested that it would be difficult for the authorities to constrain real wages, and that an incomes policy was the best available alternative. At the least, it reflected a clear awareness of the need to keep real wages in check and, while perhaps not permitting them to fall, it might prevent them from rising. Of course, any such effort would have to be complemented by appropriate monetary and budget policies.

The staff had usefully listed in the final paragraph of its appraisal a number of structural measures that could enhance Australia's noninflationary growth, Mr. Polak noted. The ideas that the staff had mentioned were not original, but they needed to be stressed as a warning to the authorities. Equally impressive was the staff's analysis of the detrimental effects of protectionist measures against Australia's exports and of the domestic assistance to Australian industry that had been induced by the restrictions abroad. The description warranted special attention by authorities in other countries.

Mr. Tvedt said that the recession had started later in Australia than in other countries, but the adverse effects had been serious, including a reduction in economic activity, a sharp rise in unemployment, and a rapidly growing fiscal deficit. Labor market rigidity had been an important contributor to the recession, having been largely responsible for the sharp increase in unemployment and partly responsible for the abrupt reduction in private investment.

At the beginning of 1983, Mr. Tvedt continued, the authorities had faced formidable tasks, and the present Government had wisely given high priority to reducing both inflation and unemployment. If the strategy was to succeed, the authorities would have to rely on an effective incomes policy together with appropriate fiscal and monetary policies. It should be clear to the unions that the wage increases of the previous two years were inconsistent with the objective of avoiding a further rise in unemployment, and that a flexible wage policy would have to be maintained if unemployment was to be cut significantly. The Government's decision to pursue an expansionary fiscal policy carried some risks. While that policy might yield some positive results in the short term, if foreign demand grew more slowly than was expected and domestic cost increases were not contained, the competitive position would deteriorate unless the exchange rate was permitted to depreciate. However, a depreciation would operate through the indexation mechanism to increase inflationary pressures and, perhaps, the rate of unemployment; and inflation was likely to receive a further impetus from the fiscal side. Alternatively, if the increase in economic activity met the authorities' expectations, he fully agreed with the staff that the fiscal deficit would have to be reined in once the recovery had become firmly rooted. Given the inflationary effect of a currency depreciation, it would be important to maintain adequate competitiveness over time by limiting domestic cost increases.

The tasks facing the monetary authorities were particularly difficult, Mr. Tvedt remarked. He was worried that the proposed sale of government securities to the nonbank public might have an adverse effect on asset holdings by the banking system.

The devaluation of February 1983 had been virtually fully offset by subsequent developments, Mr. Tvedt noted. In terms of relative unit labor costs, the exchange rate was at a historic high level. In those circumstances, and given the uncertain outlook for wages, it would be useful to have a further comment on the likely exchange rate policy in the coming period.

Little seemed to have been done to eliminate trade restrictions, Mr. Tvedt remarked, and, although Australia unfortunately faced many restrictions in its export markets, the Australian authorities would be well advised not to use them as an excuse for applying their own restrictions. Protection was not an effective tool for reducing unemployment over time.

The Australian economy was at an important juncture, Mr. Tvedt concluded, and it was difficult to tell in which direction it was likely to move. He hoped that the authorities would be able to implement their strategy successfully, and he was particularly concerned about future wage developments, as they would be an important factor in determining the authorities' success. Apparently Australia's economic system lacked sufficient flexibility, thus making it all the harder for the authorities to achieve their objectives. Finally, Australia's intention to make an early repurchase in respect of the 1982 purchase under the buffer stock financing facility was welcome.

Mr. Kabbaj commented that there had been major changes in the Australian economy since 1981. There had been a downturn in economic activity following a substantial decline in fixed investment by the private sector, and the rate of unemployment had almost doubled, to 10.5 percent, in the second quarter of 1983. In addition, the budget deficit had increased significantly, and the rate of inflation in Australia had remained more than twice as high as the average for industrial countries, although there had been a declining trend since end-1982. The main causes of the deterioration in Australia's economic outlook were the adverse effects of the world recession, the high level of domestic and international interest rates, and, to a smaller extent, the worst drought in the country's history. However, the staff had clearly shown that soaring labor costs and depressed industrial productivity in Australia had precipitated the economic downturn.

The program adopted by the Government elected in March 1983 was aimed at reducing the double-digit unemployment rate and at continuing and strengthening the anti-inflationary effort of the previous Government, Mr. Kabbaj remarked. The program seemed appropriate for meeting short-term objectives, but the authorities had not satisfactorily addressed underlying economic distortions and the need for further action to sustain and strengthen the economy later on. In the area of prices and incomes policy, the authorities intended to restore business profitability, which had been eroded during the previous two years. That objective, however, seemed inconsistent with the continued indexation of wages, although the call for the Australian Council of Trade Unions to use the official consumer price index as the basis for measuring inflation in 1984 should ensure some reduction in real wages and labor costs and help to prevent another round of real wage increases. In addition, the Government was committed to socially oriented policies and to seeking a broad consensus among unions, business, and government on the main economic issues. The success of the Government's effort would depend upon its maintaining a firm fiscal and monetary policy stance.

The 1983/84 budget, Mr. Kabbaj went on, included new spending programs focused particularly on job creation and public housing that, while providing a stimulus to economic activity, ran the risk of building up new inflationary pressures. On the other hand, the authorities were taking steps to avoid an undesirable crowding out of credit to the private sector, and, despite the new spending programs, some spending cuts had been made and the fiscal deficit in 1983/84 should be lower than had been projected by the previous Government. In the monetary policy field, the projected moderate range for monetary growth seemed consistent with the need to accommodate the increases in wages and prices, although the various indicators would have to be watched closely. In addition, the staff had underscored the risk of a contribution by the balance of payments to money creation, which the staff felt could be avoided only by allowing the Australian dollar to appreciate. Such a move, however, would erode Australia's competitive position at a time when the external current account deficit was already large and Australia faced extensive restrictions on its main exports.

While the policy mix of the new Government provided a little room for maneuver, Mr. Kabbaj concluded, the economic program had restored domestic and foreign confidence, thereby clearly improving the prospects for containing the inflationary pressures and resuming business investment as the economy grew. Finally, the authorities were to be commended on their decision to increase their official development assistance in 1983/84.

Mr. Ainley said that he agreed with speakers at EBM/83/161 who had thought that the gap between the present and the previous Article IV consultation with Australia was excessive. The new Government was to be commended for having acted quickly in March 1983 to deal with the immediate problems. Its quick response had helped to restore confidence and to provide the economy with much-needed breathing space. The authorities' intention of dealing simultaneously with the problems of inflation and unemployment was also commendable, although ambitious, given the recent experience of other countries.

The authorities' three-pronged strategy was attractive in theory, Mr. Ainley continued, but, as Mr. Prowse had noted, it entailed risks. He shared the staff's concern about the growing size of the public sector borrowing requirement. If crowding out was to be avoided, the authorities would have to find the right time--and find it fairly soon--to move toward fiscal restraint. Their task could perhaps be made easier if the ways to reduce the structural component of the budget deficit were planned well in advance.

The Government's ability to sustain the recovery would depend to a great extent on its success in reducing inflation, Mr. Ainley remarked. The consensus that the authorities had obtained on an incomes policy was an encouraging step in the right direction, especially as experience in other countries suggested that they would run certain risks if indexation became permanent. It was important for Australia, as well as other countries, to link wage increases more closely to gains in productivity.

A firm monetary policy was an essential complement to wage restraint, Mr. Ainley said, and there would be no room to relax the monetary targets at the time of the midyear review. He, too, would have welcomed a fuller analysis of the interplay between exchange rate management and monetary growth; on balance, he tended to agree with Mr. Joyce that more flexibility in managing the exchange rate was required.

Useful comments on structural issues in Australia had been made by Mr. Polak, Mr. Ainley remarked. He hoped that the authorities would continue to make progress in deregulating the financial system. That objective was particularly important at the present stage, when new instruments and techniques could help in the financing of the large public sector borrowing requirement.

As previous speakers had stressed, Mr. Ainley noted, it was unfortunate that protectionist barriers in Australia remained high. But free trade and structural adjustment based on the principle of comparative advantage should be a two-way process. The staff estimate of the financial loss to Australia, in terms of exports forgone, as a result of trade restrictions in other countries was striking.

The authorities were to be commended for their present and prospective aid performance, Mr. Ainley commented, and for their decision to make an early repurchase in respect of their purchase under the buffer stock financing facility. The early repurchase by Australia was an example of a member country fully and swiftly meeting its undertakings to the Fund.

Mr. Zhang considered that Australia's problems were clearly due mainly to the country's substantial vulnerability to economic fluctuations which, in turn, was traceable to its position as a major world supplier of cyclically sensitive metals and energy items. The recent developments in Australia's economy should be seen as a delayed consequence of the international economic conditions in 1980 and early 1981, when high oil prices and the rapid expansion of international liquidity had encouraged active interest in the development of Australian resources and had caused a resource development boom, placing wage earners in the metals trade sectors in a very favorable wage bargaining position. The resultant large wage increases in those sectors had been followed by more generalized wage pressures.

He did not believe that the failure to implement a more active labor market policy and to secure a reduction in protectionism was an important factor in the sharp recession in 1982, Mr. Zhang said. On the contrary, the recession had been inevitable with the collapse of the resource investment boom, the appearance of extraordinarily high foreign interest rates, the intensification of the recession abroad, and the weakening of the rural economy caused by the drought.

The present Government was to be commended for having taken quick and decisive steps in various economic policy areas immediately after taking office in March 1983, Mr. Zhang commented. One of the main features of the Government's policy stance was an expansionary fiscal policy whose stimulatory effect, together with the anticipated recovery in foreign demand, should support a strong cyclical upswing in the coming year. The fiscal policy, which was backed by the agreed incomes policy and other monetary and exchange rate measures, would restore the conditions needed for steady, noninflationary and self-sustaining growth in the medium term.

He doubted whether the staff's conclusions about the rise in the share of the public sector borrowing requirement in GDP were valid, Mr. Zhang said. Since GDP had been depressed by the various factors that he had mentioned, was it correct to assume that the rise in the share of the public sector borrowing requirement of GDP was an indication that the fiscal deficit must be reduced in order to avoid crowding out, a widening of the current account deficit, and a weakening of the overall balance of payments position? Why did the staff not advocate a depreciation of the exchange rate, as it had often done in previous assessments of countries where domestic prices had increased more rapidly than the prices in the major trading partners?

In view of the restrictions that had been imposed by a number of Australia's trading partners, Mr. Zhang commented, it would be unrealistic to expect Australia to reduce its protection. Finally, he was pleased that Australia had decided to make an early repurchase of its drawing on the buffer stock financing facility.

Mr. Malhotra noted that in his opening statement Mr. Prowse had mentioned that his authorities broadly agreed with the staff appraisal. The Government's major objective of reducing unemployment as well as inflation seemed appropriate. The policy mix was usually an important issue in any country trying to achieve a number of objectives simultaneously. The Australian authorities, fully aware that the budget deficit should not cause a significant increase in liquidity, were determined not to monetize the deficit. That approach, if consistently pursued, would help in moderating inflation.

Incomes policies were generally controversial, Mr. Malhotra remarked, but in the case of Australia the broad consensus that the Government had encouraged should prove useful. It was of course possible that such a broad consensus might not endure for a long period, and Mr. Prowse had stated that, if the accord was not adhered to, the authorities were prepared to consider other measures, in both fiscal and monetary areas. Australia's experiment with an incomes policy was in any event worth trying; and thus far, the consensus that had been promoted by the authorities appeared to be holding up.

He agreed with the staff, Mr. Malhotra said, that monetary policy was of crucial importance. Apparently, there had been some overshooting of the monetary targets in the early months of 1983, and in the coming period the authorities should pay attention to the need to control monetary growth.

He did not clearly understand the views expressed by the staff and Mr. Prowse on Australia's exchange rate policy, Mr. Malhotra remarked, especially as the rate of inflation in Australia was much higher than the rate in its trading partners. Finally, Australia's decisions to make an early repurchase from the Fund and to increase official development assistance were welcome.

The staff representative from the European Department explained that the long period between consultation discussions with Australia had been due to an unfortunate set of circumstances, and not to a decision of the authorities. The latest set of discussions was to have taken place at the end of 1982, but the staff had been under great pressure at the time and had been unable to send a mission. The discussions had been rescheduled for March 1983, but the Government's decision to call early elections had led to a postponement. After the elections the authorities had been under pressure to create and implement a program for the new Government. The authorities took Article IV consultation discussions seriously and spent considerable time participating in them. It had not been possible for them to devote their full attention to consultation discussions until recently.

A paper had been issued in connection with the March 1983 exchange rate devaluation that the authorities had decided upon mainly in response to the large capital outflows at the time of the national elections in March 1983, the staff representative commented. At present, the devaluation had been entirely reversed. The Campbell Committee on the Australian financial system had proposed that Australia move to a free float. The recommendations of the Campbell Committee were being examined by a new committee that had been appointed by the present Government. The conclusions of the new committee had not yet been published, but some of the proposals of the Campbell Committee had already been implemented, including the deregulation of interest rates, sales of bonds, and certain adjustments in the exchange rate system which had been described in the staff report, including changes in the forward market, which had become a completely free market.

The possibility of a floating exchange rate, perhaps with occasional intervention, was still very much under review, the staff representative went on. That kind of system obviously raised certain problems for a country whose currency was not a major one, where capital flows could be large and the exchange rate could be volatile. Therefore, a balance had to be found between the advantages of a floating rate system and the advantages and costs of the present exchange rate system. If capital inflows resulting from interest rate differentials were not reflected in a change in the exchange rate, the authorities had to adjust the domestic interest rate in order to reduce the differential, or they had to permit the money supply to increase to an extent that might not be desirable. Hence, as Mr. Joyce had stressed, there were clearly costs associated with Australia's present exchange rate system. There was also of course considerable advantage for a relatively open economy like Australia's in maintaining an exchange rate system that was not characterized by considerable volatility. In any event, exchange rate appreciation was the only conceivable response, other than capital controls, to large capital inflows. As the staff understood it, capital controls were not being considered by the authorities. Australia's experience with such controls, in 1972, suggested that they were not effective.

The staff's misgivings about the present fiscal policy, and its statement that the Government's policy mix might well yield good results in the coming 12-18 months, were not inconsistent, the staff representative remarked. The fiscal stimulus could be expected to provide a boost to economic activity in the short term, but could cause problems when the economy expanded and crowding out became a possibility. Indeed, two forms of crowding out were already evident. The first was the usual crowding out resulting from the upward pressure on interest rates resulting from government borrowing in the financial markets. The second was what the Australians termed "exchange rate crowding out," referring to an appreciation of the exchange rate caused by an increase in interest rates and the resulting crowding out of activity in the export- and import-competing sectors. Unless the need for government borrowing in the financial markets was reduced, one or both of the two forms of crowding out that he had described would appear.

The question had been raised, the staff representative recalled, why the staff had paid attention to the ratio of the public sector borrowing requirement to GDP. It was true that, in the short run, an increase in the public sector borrowing requirement had a fairly limited adverse effect. One of the important questions in the fiscal policy area was whether the rapid increase in expenditure would be reversible when the economy expanded. The staff had noted that much of the expenditure in Australia was in the form of transfers, welfare spending, and national health insurance payments, whose upward trend probably would not be easy to reverse. In addition, there was an important relationship between the public sector borrowing requirement and the liquidity in the economy. The public sector borrowing requirement measured the amount of borrowing that the Government must undertake in the financial markets, and the result of the borrowing might include the two forms of crowding out that he had described. It was true that if domestic investment was depressed, the crowding out pressure in the form of an increase in interest rates might not be strong. However, experience suggested that such pressure developed rapidly when there was a large increase in the public sector borrowing requirement and in the sales of public securities.

The question had been raised why the staff supported an exchange rate policy that resulted in a net appreciation of the exchange rate at a time when the competitiveness of most Australian industries was not particularly strong, the staff representative remarked. The answer was that, when seen in a broad perspective, Australia's external position was not a cause for great concern. The country normally had a sizable external current account deficit that was financed by capital inflows. Australia was usually a capital importer and had substantial opportunities to put imported capital to good use. Hence, the existence of the current account deficit was not reason enough to suggest a depreciation of the exchange rate. In addition, it was important to distinguish between the nominal and real exchange rates. In order to improve competitiveness, Australia required a depreciation of the real exchange rate. Given the high rate of inflation in the country, the best way to achieve such a depreciation was to improve the price performance and to reduce costs within the economy, thereby bringing the rate of inflation in Australia closer to the average rate in the industrial countries as a group; otherwise, Australia would enter a cycle of devaluations and high rates of inflation without solving the fundamental problem of inflation.

The authorities maintained what they called conditional projections, rather than monetary targets, the staff representative explained. The prospects for meeting the conditional projections were not good, as through September--the latest month for which 1983 data were available--the money supply had still been growing at a rate of some 13 percent, well in excess of the target range, mainly because of the sizable capital inflows and, to some extent, because of the borrowing by the Government, although most of the monetary effects of the borrowing had been offset by sales of securities to the nonbank public. It was important to note that the authorities had taken steps to ensure that the rate of monetary expansion would be reduced. The strong appreciation of the exchange rate since the devaluation in March 1983 was an indication that, despite the cost in terms of competitiveness, the authorities were prepared to adhere to the monetary targets. That decision had been a particularly difficult one for the authorities. In their effort to offset excessive money creation, the authorities would probably reduce the volume of credit to the private sector only as a last resort.

The staff expected a reduction in the rate of inflation despite the high rate of monetary expansion, the staff representative remarked. In that connection, however, it was important to distinguish between the short term and the medium term, and between recorded inflation and the underlying rate of inflation. In the short run, price performance would be favorably affected by the lagged effect of the wage freeze of December 1982 to September 1983. In addition, in 1984 there would be a reduction in the consumer price index of about 2.5 percentage points, because the health insurance premiums would no longer be included in the index. The changes in the arrangement for financing the health insurance scheme would take place in the early months of 1984. The appreciation of the exchange rate should also have a favorable effect on price performance. However, if the rate of monetary expansion remained at 13 percent, the positive effects on prices that he had described would be offset by domestic cost pressures.

In economic terms, the staff representative commented, subsidies were preferable to protection. For instance, the introduction of an import duty on steel would require domestic users of steel to pay a higher price that included the import duty. If instead a subsidy was given to domestic steel producers, steel would be somewhat cheaper for domestic users. The costs of subsidies were more visible than the costs of quotas and tariffs, which tended to be spread over a large number of users, and were clearly defined in the budget.

The staff did not expect significant strains on the incomes policy to appear before 1984, the staff representative from the European Department said. Workers might have to accept cuts in real wages as a result of the change in the financing arrangements of the medical health system. In addition, there had already been cases in which some strong unions--the food processing, building, and oil sectors--had already managed to obtain, even during the period of the wage freeze, wage increases that were not in accordance with the spirit of the freeze. Hence, there was already some evidence that it might well be difficult to keep the incomes policy intact. The staff's misgivings about the incomes policy were traceable to the effects of the financial policies that were being maintained together with the incomes policy. It seemed clear that, if monetary policy was excessively expansionary, the incomes policy could not be kept in place. An incomes policy could not be counted on to contain inflation when other major policies were out of line with the medium-term target for inflation.

Mr. Prowse commented that the staff had developed a good and cooperative relationship with the authorities that had been beneficial to the recent discussions and bode well for future consultations. A general point he wished to make, which a number of speakers had noted, was that Australia's economy lagged behind the economies of European countries in cyclical movements. Hence, it was possible to gain the incorrect impression that the Australian authorities had failed to learn the economic policy lessons of the European economic experience of the late 1970s.

As the staff had remarked, Mr. Prowse noted, an incomes policy was useful only when it was complemented by satisfactory measures in other policy areas. The Australian authorities believed that their incomes policy would ameliorate some of the costs of the adjustment process. The Conciliation and Arbitration Commission had conducted a major review of wages and the system for setting wages after the new Government had been elected in March 1983. As a result of the review, the centralized wage setting system, which had prevailed in Australia in one form or another--occasionally including types of indexation--for many years, had been re-established. In its ruling, the Commission had specified that before any union could enjoy the benefits of the central wage decision, it had to proclaim publicly its unequivocal commitment to the wage fixing principles and accept the need that the Government had stressed for flexibility in real wages depending on circumstances. While there had been some strains in the wage determination system, compliance by the unions thus far had been satisfactory and the accord had been kept intact. Importantly, the Council of Trade Unions, which was the main body of Australian unions, had recently renewed its support of the accord.

The direct cost of government assistance to industry, including the steel industry, which some speakers had mentioned, was a relatively small part of total government outlays, Mr. Prowse said. In the present budget, total direct assistance to all industries, including tourism, was somewhat less than US$1 billion, equivalent to about 2.5 percent of total budget outlays, compared with 2.9 percent one year earlier.

Executive Directors had accurately noted the distinction between trade protection and assistance to industry through the budget, Mr. Prowse remarked. On the broad policy of trade protection, the Prime Minister had committed himself to maintaining employment in the present difficult economic climate and had stated that, in the longer run, Australia would need predictable and gradual reductions in protection in order to achieve sustainable economic growth. He hoped that those long-term objectives could eventually become short- and medium-run goals. As a country heavily dependent on the export of primary products and raw materials, Australia would require access to markets in order to participate in the general economic recovery. While authorities' policy on protection was a pragmatic one, the costs of protection were recognized by the authorities.

He had no information, Mr. Prowse continued, on the timetable for implementing measures that had been recommended by the Martin Committee, the successor to the Campbell Committee of Inquiry into the economy. However, the response to the recommendations was seen as a matter of urgency and would probably emerge in coming months. The Campbell Committee had reviewed the whole structure of the economy and had made hundreds of proposals, among which was a recommendation to reduce the regulations affecting the operations of foreign banks and the foreign exchange market. Sound measures could be expected to be adopted in an evolutionary manner, and a number of foreign banks would perhaps be permitted in Australia in the future; there were already some foreign banks in the country. In addition, the country had moved toward a freer foreign exchange market.

The Government was reviewing foreign investment policy, but application of the existing guidelines had been consistent and in line with past practice, Mr. Prowse remarked. He understood that the Government intended to emphasize policy continuity while perhaps making some appropriate changes. The authorities clearly understood the potential adverse effects of a general requirement of 51 percent local ownership, and he doubted whether the requirement would be applied widely after the Government's inquiry into foreign investment policy was completed.

He wished it to be clearly understood, Mr. Prowse said, that the authorities were not acting incautiously in the field of external debt. As a proportion of GDP, government debt had fallen from 21.6 percent in 1960 to 3.8 percent in 1972 and 3.6 percent in 1982. There had been fairly rapid growth in recent months in private capital inflows, but that too should be kept in perspective. Thus, in mid-1982, total debt, including government debt, had amounted to 15.8 percent of GDP, compared with 13.9 percent in 1972. Hence, over a whole decade, the ratio of debt to GDP had increased by 2 percentage points, a small increase for a capital importing country. The present capital inflow was caused by supply, as well as demand factors and was a response to the long-term prospects for stability in Australia and to the country's rich resource base; interest rate and exchange rate differentials were important but perhaps not critical factors. He was not of course saying that the recent capital inflows were not causing problems. However, recent technical changes in the exchange rate system were, in his view, more significant than had generally been thought. Although the staff reports had referred to the exchange market as being a highly managed one, the forward market for currency settlements on trade accounts had been freed, exchange controls had been largely removed, and commercial banks would be responsible for maintaining forward books on foreign exchange; they could take positions on and hold balances in foreign exchange. All those steps could significantly alter the operation of monetary policy and mechanisms and the determination of domestic interest rates. The new measures should constitute a significant step forward for both the exchange market and the management of monetary policy. In the future, interest rates would be more strongly influenced by market forces than in the past.

Crowding out, in the usual sense of the term, had not been occurring in Australia, Mr. Prowse remarked. However, unless the budget deficit was brought down, some crowding out might occur in the coming year. But for the present, interest rates were declining, and the Government had been able to issue large amounts of securities in responding to the inflow of capital. The Government had been trying to do more than merely finance the deficit through its security issues. The risk was that, as the domestic economy improved, the demand for capital in the domestic market by the private sector would take place at a time of continuing demand by the private sector. At present, however, the capacity of the banks to lend to industry was far from fully utilized. Most Australian industries were operating well below capacity, and there seemed to be little or no competition among them for funds.

As for the possibility that the size of the public sector would become excessive in the long run, it was useful to note that Government's share of GDP had increased at a rate of about 1 percent a year over the previous decade. The total public sector, including state, local, and federal government, currently accounted for only about 42 percent of GDP, a relatively small share compared with the European industrial economies.

The Chairman made the following summing up:

The Executive Directors noted that Australia's economic situation had undergone a marked transformation since the last consultation, when Australia was enjoying a period of rapid economic growth; re-emergence of inflation and an acceleration of wage increases eventually had made the pace of economic activity unsustainable. Directors noted that weak world trade and commodity prices and a severe drought had combined to push the economy into a deep downturn and had led to an unprecedented rise in unemployment.

Directors noted that the new Government's economic strategy, centered around an expansionary fiscal policy, underpinned by a compact with the trade unions, was an ambitious effort in promoting both a recovery of activity and a gradual deceleration of the rate of inflation. Although many Directors saw the case for having recourse to an incomes policy, especially in the Australian context of strong and independent trade unions, they believed that the Government's strategy entailed serious risks for the period beyond the next 12 months or so. A number of Directors emphasized that excessively expansionary financial policies might put the incomes policy under severe strain and put much of the burden of price and incomes moderation on monetary policy.

Directors expressed considerable concern about the very rapid increase in the public sector borrowing requirement. Noting that the expansionary stance of fiscal policy stemmed almost entirely from a very rapid rise in public spending, they stressed that determined efforts at expenditure restraint were essential in order to reduce the structural component of the deficit. Many Directors were apprehensive that a failure to rein back the fiscal deficit might crowd out private sector activity and push up interest rates and exchange rates, thus undermining the basis for a sustained recovery.

Directors fully endorsed the authorities' view that it is the private sector that must provide the desired expansion of employment opportunities. They also agreed with the authorities that a reduction in real wages and improved business profitability were essential to realize these opportunities. They accordingly emphasized the importance of achieving and safeguarding a reduction in real wages. In the view of several Directors, full wage indexation should not become a permanent feature of policy.

Directors also emphasized the pivotal role of monetary policy in ensuring a sustained reduction in the rate of inflation. While noting with satisfaction the recent decline in the rate of inflation to within a single digit, Directors felt that it was no cause for complacency, since inflation was still well above the level of Australia's main trading partners.

In the recent past the improvement in business confidence, among other things, had stimulated large capital inflows, but this development had tended to interfere with the conduct of monetary policy as the authorities had not always succeeded in offsetting the impact of these inflows on the money supply, causing monetary growth to exceed the target set by the authorities. Directors noted the willingness shown by the authorities in recent months to let the exchange rate appreciate. While some Directors were concerned at the effect of an appreciating exchange rate on competitiveness, there was general agreement that a determined effort to restrain monetary growth was essential to sustain the progress made in reducing inflation. A few Directors noted the recent and prospective rise in Australia's external indebtedness.

Finally, while deploring the rising trade barriers faced by Australia's agricultural exports in overseas markets, Directors stated that Australia's own interests would be best served by a gradual reduction in the extensive protection accorded to the manufacturing sector and urged the authorities to resist any measures to intensify protection.

Directors commended the authorities for increasing their official development assistance and welcomed the prospective early repurchase in respect of last year's drawing under the buffer stock financing facility.

Several Directors noted the long delay since the last consultation and welcomed the intention to hold the next Article IV consultation with Australia on the standard cycle.

2. MAURITIUS - REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the first review under the stand-by arrangement for Mauritius (EBS/83/234, 10/31/83).

Mr. Orleans-Lindsay, speaking for Mr. Alfidja, made the following statement:

Six months ago, the Executive Board had the opportunity to conclude the 1983 Article IV consultation with Mauritius and approved its request for a 15-month stand-by arrangement. My authorities share the view expressed by Directors and the staff that they have to persevere in their adjustment efforts, which, so far, have yielded encouraging results.

Mauritius, it might be useful to recall, experienced a formidable economic expansion as a result of a substantial increase in international sugar prices between 1972 and 1975. Since then, except for the years 1980 and 1981, not only have international sugar prices collapsed, but also the island itself has had to face dramatic climatic conditions entailing major adjustment efforts, which have been supported by stand-by arrangements with the Fund. The present stand-by arrangement differs from the previous ones because it emphasizes supply-side considerations while consolidating the gains already made; the previous ones were geared mostly to demand management policies.

The real sector of the economy has performed relatively well over the recent period, despite the adverse terms of trade and the unfavorable weather conditions. Real GDP is expected to have grown by 7.2 percent in 1982/83 compared with the 5.5 percent originally forecast and the 5.3 percent growth in 1981/82. This improvement in the performance of the real sector is largely a reflection of the recovery in sugar output. It should be pointed out, however, that the sugar industry, which still remains the backbone of the Mauritian economy despite all efforts at diversification is going through a trying period. A commission of inquiry has recently been set up to recommend ways to improve the profitability of the industry. The rate of inflation decreased to 7.4 percent in 1982/83, compared with the 13.34 percent and 26.5 percent prevailing in 1981/82 and 1980/81, respectively. This achievement is a testimony to the success of the prudent demand management policy adopted by the authorities.

In the fiscal area, the authorities have been able to reduce the budget deficit to an estimated 9.9 percent of GDP in 1982/83, compared with the 13.9 percent and 12.8 percent of 1980/81 and 1981/82, respectively. In order to rely more on domestic nonbank sources to finance the deficit, the Government introduced in 1983 an anonymous bearer bond scheme, which generated Mau Rs 35 million in the second half of the fiscal year. The Government is also strengthening its efforts to mobilize savings. Following the liberalization of the interest rate structure, all ceilings on lending rates have now been removed. Thus, in 1982/83 the real rate of interest on one-year time deposits has been 4.6 percent. In addition, the method of credit allocation has also been modified with a view to mobilizing savings.

On the external front, the current account deficit is estimated to have declined to 5 percent of GDP in 1982/83, compared with 15.5 percent and 5.7 percent prevailing in 1980/81 and 1981/82, respectively. The authorities are concerned about the protectionist measures taken by some industrial countries which, together with a lower demand due to the world recession, adversely affected export performance in 1982/83. The authorities, having decided to reduce their commitments vis-à-vis the Eurocurrency market, have estimated that capital inflows in 1982/83 decreased by 48 percent over the previous year.

The external debt situation of Mauritius continues to be a major preoccupation for the authorities. The reduction of commitments in the Eurocurrency market is therefore regarded as an important step in implementing measures for easing the external debt burden.

The immediate prospects of Mauritius are generally favorable. Thus, notwithstanding the 11 percent reduction of sugar output, a legacy of the lingering drought, real GDP is expected to grow by 3.1 percent in 1983/84. In the fiscal area, the authorities have undertaken to reduce further the budget deficit to about 8.8 percent of GDP in 1983/84, which is to be accomplished by a further increase in revenue and grants. Current expenditure as a percentage of GDP is also expected to decline over the same period, to 24.7 percent, the lowest ratio since 1979/80. In the external sector, the current account deficit is expected to decline to about 4.5 percent of GDP.

Finally, there were two issues which appear to have attracted the attention of Executive Directors at the last discussions: wage policies and the medium-term outlook of the balance of payments in relation to the revolving nature of Fund resources. First, concerning wage policies, my authorities have had differences of views with the staff about instituting direct negotiations between employees and employers at the level of the firm or industry, instead of the traditional global wage award, the former being expected to generate wage settlements more in line with the changes in productivity. The authorities have now decided that direct negotiations will indeed prevail starting in fiscal year 1984/85; they will set an example for the private sector when, as already decided, they link wage settlements in the public sector to productivity changes.

Second, concern was expressed that the revolving character of Fund resources appears to be at variance with Mauritius's continuous use of these resources. My authorities are determined to reduce their external indebtedneess vis-à-vis both the Fund and the Eurocurrency market. However, this objective cannot be attained in a short period. As the adjustment efforts continue with the same success and the medium-term improvements take place in the balance of payments situation, the Government expects to be able to reduce its use of Fund resources. I, therefore, recommend that the Board approve the proposed decision.

Mr. Ismael considered that the authorities were to be commended for the effective implementation of the adjustment program. Some of the problems that had caused the financial imbalances in the period 1979-81 were more or less structural in nature, and a quick solution to them could not be expected. In the circumstances, it was not surprising that the Fund had approved four consecutive stand-by arrangements to help the Mauritian authorities correct the problems facing the economy. He wondered whether an extended arrangement would not have been more appropriate. The longer-term perspective of such an arrangement would perhaps have placed the authorities in a better position to address at an early stage the structural problems of the tariff structure, company taxation, and the general tax administration.

The progress that had been made in reducing the external current account deficit was encouraging, Mr. Ismael said, but the rapid increase in the debt service burden projected for 1983/84 was a cause for concern. There had been rapid growth in the external debt and a deterioration in the debt profile in the period June 1980-June 1981, when Mauritius had been implementing a program, supported by a stand-by arrangement, that apparently had been insufficient. He was also concerned that, despite the growing debt burden, the level of investment had been declining since 1978, both in real terms and as a percentage of GDP. He warmly welcomed the effort that the authorities were making to enhance domestic investment and to reduce supply bottlenecks with the financial support of the Fund, the World Bank, and individual donor countries. That effort, together with the expected improvement in the world demand for Mauritius's exports as the recovery continued in some industrial countries, should contribute significantly to the strengthening of underlying economic growth and should help to improve the employment situation. However, the need for a continued effort by the authorities to increase domestic savings to sustain adequate levels of investment should be underscored. In the past three years, the performance of domestic savings had been weakened by the savings performance of the government sector. The authorities should be encouraged to stimulate private sector savings. The recent revenue measures were important, but no less so than the need for a tight rein on recurrent expenditures. The recent liberalization of the structure of interest rates was a commendable step forward in the effort to encourage financial savings.

He shared the authorities' concern about the widening spread between deposit rates and lending rates that had probably contributed to the slack investment demand, Mr. Ismael commented. The predominant role of Government in the demand for total credit had significantly contributed to the gap between deposit and lending rates. Since 1978 the rate of increase in the banking system's net claims on the Government had been substantially higher than the system's net claims on the private sector. In addition, the Government had borrowed substantial amounts from the domestic nonbank sector to finance deficits. A sustained effort to reduce the government budget deficit would have to be made if private investment was to be stimulated. The recent reduction of the discount rate might help to reduce bank lending rates, but, with the continued tight credit ceiling, it might encourage a buildup of foreign balances held by commercial banks.

The measures that had been introduced to reduce the quantitative import controls and the price controls were major steps toward increasing the efficiency of resource allocation and stimulating production, Mr. Ismael remarked. The authorities should be encouraged to continue to move in those directions. The competitiveness of the Mauritian rupee would have to be preserved through sufficiently flexible management of the exchange rate. Finally, the proposed decision was acceptable.

Mr. Blandin said that he fully agreed with the emphasis on supply-side measures while continuing the process of adjustment under the 1983/84 program. It would be crucially important to enlarge the resource base and diversify the economy away from sugar production in order to reduce the dependence on a single commodity that made Mauritius particularly vulnerable to external shocks. Continued demand restraint would also be needed to avoid renewed external and internal imbalances. It would certainly not be easy to achieve those objectives simultaneously. In using the various instruments of economic policy the authorities would have to strike a proper balance between their major objectives. In that connection, some aspects of the program might prove to be contradictory. The staff had correctly underscored the importance of improving the financial position of the sugar industry. In 1982/83 the Government had reduced the sugar export duties, pending the final conclusions of a report to be issued by a commission on the financial position of the sugar sector. It was therefore puzzling to note that in June 1983 the sugar export duties had been raised to the pre-1982/83 level. Indeed, the draft report of the inquiry commission included a recommendation for abolishing the sugar export duty. A further comment on the economic rationale for the duty would be helpful.

He understood the need for maintaining positive real interest rates in order to encourage savings and to improve the control of the pace of credit expansion, Mr. Blandin continued. But the current deposit rates were 11 percent and their minimum lending rates were at least 14 percent, while consumer prices had risen by 7.4 percent in 1982/83 and were projected to rise by 9 percent in 1983/84. As a result, real lending rates would be more than 5 percent in 1983/84 and would probably adversely affect the financial position of the sugar sector, which was heavily indebted. The high rates might also increase the level of public expenditures. Interest on the public debt had increased by 24 percent in 1982/83 and was estimated to continue growing in 1983/84. The decision of October 1983 to lower the bank rate and treasury bill rate by 1 percent was welcome, but he wondered whether additional steps in that direction should not be taken, especially as in 1983/84 the sugar industry was expected to increase its borrowing by 21 percent in order to pay high interest rates and the increase in the sugar export duty. An increase of 1 percentage point in interest rates represented Mau Rs 55 million in interest payments by the Government.

At present, Mr. Blandin noted, the real effective exchange rate was basically at the same level as in 1975. However, in discussing wage policy the staff had clearly advocated a reduction in real wages in order to improve competitiveness. Such a reduction might prove difficult to achieve, and he wondered whether competitiveness could not be improved instead by adjusting the exchange rate. However, he broadly agreed with the staff appraisal. The economy had made good progress toward adjustment over the previous three years, despite the difficult external environment. The authorities were to be commended for their commitment and achievements, including the implementation of some obviously painful measures, for instance, the nearly 50 percent reductions in the subsidies on rice and wheat flour in 1983/84. The balance of payments prospects clearly suggested the need to continue the adjustment efforts in the coming years. The debt service ratio was expected to remain at about 25 percent until 1985/86; and even that projection was based on the optimistic assumption of a 5 percent annual increase in world trade.

In the circumstances, and especially in light of the repurchase burden in 1984/85 and 1985/86, the Fund would have to remain involved in Mauritius's adjustment effort, Mr. Blandin commented. The Fund should avoid being dogmatic in determining the amount of assistance to be made available to member countries, particularly those that were making strong adjustment efforts. In that connection, the increase in quotas would provide some breathing space. Finally, the proposed decision was acceptable.

Mr. Leonard said that he had no difficulty in accepting the proposed decision. The economy had responded well to the comprehensive policy measures that had been implemented since 1979, and in 1982/83 all the program targets had been met and all the performance criteria had been observed. The authorities' management of the economy had obviously been solid, and they clearly deserved the continued support of the Fund.

The staff had noted that the correction of adverse developments in the economy had involved some cost, particularly a continuing rise in unemployment, Mr. Leonard remarked. The rate of unemployment now stood at 20 percent. In addition, the rate of growth had fallen, and real incomes had continuously declined and were expected to fall further in coming years. Furthermore, the Government had had to increase the tax burden. Given the heavy cost, it was particularly regrettable that the benefits of the adjustment efforts had been reduced by the growing protectionism in some of Mauritius's industrial markets. Without adequate access to those markets, industrial development--one of Mauritius's main hopes for the future--would be constrained, thereby further damaging the employment situation. In the circumstances, the authorities' commitment to a further liberalization of imports was commendable.

The staff had concluded, Mr. Leonard noted, that the recent and prospective reductions in quantitative controls on imports and the decision to reduce the scope and rigidity of price controls should improve the allocation of resources and stimulate production. He agreed that the moves would improve resource allocation, but he doubted whether production would be stimulated. The staff report suggested that domestic consumption demand was likely to be at least sluggish for some time as a result of the decline in real incomes, and any further rise in prices following the relaxation of price controls would further dampen real demand. Under those conditions, the easing of quantitative import restrictions would probably reduce the outlets for domestic goods and have a contractionary effect on production. In addition, the moves were unlikely to affect export production significantly.

He had been struck, Mr. Leonard said, by the number of island economies whose economic well-being depended on the provision of concessionary finance and grants by donors. Those kinds of aid were clearly valuable, but they could not be relied upon indefinitely and they constituted a sizable unpredictable factor for the economies concerned. The role of such finance should be examined during the forthcoming discussion on small island economies. To what extent would such finance remain important as the protectionist policies of their major trading partners were eliminated and their trade began to grow?

Mr. Kabbaj observed that Mauritius had had four consecutive stand-by arrangements. The first three had succeeded in alleviating some of the pressures on the external sector and in paving the way for the introduction of fundamental adjustment measures. The adjustment measures under the present program were designed to strengthen the supply side of the economy while continuing the adjustment strategy. It was assumed that the present program would result in substantial progress toward higher rates of economic growth, larger investment outlays, and increased employment opportunities while the progress toward reducing the financial imbalances was maintained.

The performance thus far under the present program was encouraging, Mr. Kabbaj considered. The targets for 1982/83 had been achieved, and all the performance criteria had been scrupulously observed. The external sector had performed well, and imports had been reduced. In addition, the Government had repaid a considerable amount of Eurocurrency loans and had decided to avoid such loans in the future. On the fiscal side, the overall budget deficit had been below the target, although that had occurred mainly because of a reduction in capital expenditure due to delays in project implementation that were not in keeping with the authorities' emphasis on expanding the real sector. In addition, the increase in net domestic borrowing, including recourse to the domestic banking system, had been larger than expected.

In the real sector, Mr. Kabbaj continued, the performance of the export processing zone and of the tourism sector had been unfavorable, and the financial position of the sugar industry had deteriorated. The poor performance of the sugar industry had been due mainly to exogenous developments related to delays in the world economic recovery, but it had also been due to some of the features of the adjustment program, including the high rate of taxation, the appreciation of the Mauritian rupee, and the increases in wages and salaries. The unemployment rate had been adversely affected by delayed project implementation and by the unexpectedly low real growth of key sectors of the economy. Those developments underscored the need for the Government to adopt supplementary measures to alleviate some of the contractionary effects of the adjustment program on real growth; there was a clear need for additional measures designed to induce growth.

The assumptions for real GDP growth, sugar output, and the rate of inflation in 1983/84 were more pessimistic than earlier estimates, Mr. Kabbaj remarked. The assumption concerning the terms of trade, however, was more favorable, as a result of the increase in the average sugar export price. Small increases in both exports and imports were projected, and the current account deficit was expected to decline to the equivalent of 4.5 percent of GDP.

He attached considerable importance to the second structural adjustment loan for Mauritius, which was in the final stage of confirmation by the World Bank that included the completion of the first review under the stand-by arrangement, Mr. Kabbaj commented. The continued adherence by the authorities to the phased adjustment of exchange rate, monetary, and fiscal policies should pave the way for a major breakthrough on the structural side of the economy; in that context, continued World Bank assistance would be essential. Finally, he agreed with the staff that the authorities were committed to adhering to the program and had implemented all the measures needed to attain eventually a sustainable medium-term external position. The proposed decision should be approved.

Mr. Grosche said that he too felt that the authorities were to be commended for the successful performance of the economy under the stand-by arrangement. Despite some strains, the results under the successive arrangements for Mauritius had been encouraging.

The staff's projections were based on the assumption that no major exogenous shocks would occur, Mr. Grosche observed. On the other hand, the staff had hinted at the existence of some leeway in the external accounts, and in particular the conservative basis on which sugar exports had been projected. It should be possible to reduce the country's net debt to the Fund beginning in 1984 without placing excessive strain on the economy.

The authorities wisely attached importance to the wage rate policy in the public sector, Mr. Grosche commented. That effort should enhance the impact of the overall demand-oriented policies and should have some positive supply-side effects. However, he wondered whether the policy of allowing only flat rate increases would not lead to distortions in the labor market.

The authorities should be encouraged to increase their reliance on indirect steering of the economy through general economic measures, Mr. Grosche considered. Ideally there should be no price controls or other administrative intervention. However, he recognized that the authorities intended to phase out the existing intervention in the working of the price mechanism, and he hoped that the process would be as rapid as possible. The proposed decision was acceptable.

Mr. Malhotra noted that in its appraisal the staff had expressed its appreciation of the authorities' efforts to achieve both domestic and external balance. The proposed decision was acceptable.

Mr. Haque said that he broadly agreed with the staff appraisal and had no difficulty in accepting the proposed decision. The staff had clearly described the authorities' continued success in making adjustments under stand-by arrangements. It had stated that all the program targets for 1982/83 had been met, and all the performance criteria had been observed, largely because of the authorities' perseverance in the maintenance of generally cautious fiscal and monetary policies. Those policies, which, together with the reoriented development strategy, aimed at diversifying exports in order to reduce the country's dependence on sugar production, had been important factors in the achievement of positive real rates of growth of GDP and in the containment of inflationary pressures.

In the period ahead, Mr. Haque commented, the main challenge to the authorities would continue to be the problems in the real sector of the economy. The underlying rate of economic growth had recently been lower than the estimated growth rate of real GDP, suggesting that the adjustment process must be sustained. The targets and policies outlined in the program for 1983/84 appeared to be broadly appropriate. In particular, the emphasis on the supply side and on the need to stimulate investment activity was clearly needed if the recent decline in the ratio of investment to GDP was to be reversed, the underlying rate of real GDP growth was to be increased, and the high level of unemployment was to be reduced. In that context, the staff had remarked that substantially positive real lending rates had probably contributed to the slack in investment demand. The staff should further elaborate on the relative significance of that factor in determining investment demand. Was the reduction in bank and treasury bill rates sufficient to provide the desired investment stimulus?

Commenting on the medium-term outlook, Mr. Haque noted that the staff had recommended that, given the risk of unfavorable exogenous developments, the authorities should be prepared to strengthen their adjustment policies, if necessary. Given that fact and the nature of the country's small open economy, an important question that needed further attention was the type of long-term policy that could be available to the authorities to reduce vulnerability while strengthening the adjustment effort. The Executive Board would perhaps learn more about the question in the forthcoming discussion on small island economies. Mauritius's continued adjustment effort and its determination to achieve medium-term balance of payments viability deserved the Fund's further support.

Mr. Mtei stated that he broadly agreed with the staff appraisal and accepted the proposed decision. The authorities were to be commended for the successful implementation of adjustment measures aimed at reducing the external and internal financial imbalances. Despite the unfavorable external environment and adverse weather conditions over the previous two years and the continued deterioration in the terms of trade, remarkable progress had been made in moving toward the achievement of sustained economic growth. There had been a substantial reduction in the external current account deficit, the overall budget deficit, and the rate of inflation, and all the performance criteria for 1982/83 had been met and, in some cases, exceeded.

Despite the achievements, Mr. Mtei went on, much remained to be done. The rate of unemployment--20 percent--was still a problem and it had been made even more serious by the recent stagnation in investment and output growth. The authorities were fully aware of the situation, and the program for 1983/84 was designed to deal with the problem. The new tax measures and incentives, and the intention to exercise the needed budgetary restraint, were welcome, as they should make a contribution to stabilizing the budgetary position by helping to increase revenues and to control expenditures.

In the period under review, Mr. Mtei remarked, the average export price for sugar had declined by 1 percentage point. He hoped that the flexible exchange rate policy would eventually help to strengthen the sugar and other export-oriented industries, as well as tourism.

Commenting on wage policy, Mr. Mtei said that he agreed with the authorities that an adjustment of salaries was called for, but he hoped that in the future they would adhere strictly to a policy of wage restraint. As for the balance of payments, the outlook for the medium term was welcome, and he, like the staff, hoped that no adverse external shocks would occur. The implementation of the second structural adjustment loan from the World Bank, with its emphasis on diversifying the economy, was certainly the best way to achieve sustainable growth in the long run. Meanwhile, the evolution of the economy of Mauritius, like the economy of other similarly placed countries, would depend importantly on the world economic recovery and on the removal of protectionist measures by trading partners.

Mr. Erb said that he continued to be satisfied with the stand-by arrangement for Mauritius. He agreed with the staff appraisal and accepted the proposed decision.

Commenting on the program for the coming year, Mr. Erb noted the significant improvement in central government savings, but said that he agreed with the staff that the projected budget deficit of 8.8 percent of GDP in 1984 was too high. In seeking to reduce the deficit, the authorities should place greater emphasis on cutting expenditures, particularly certain capital expenditures. In subsequent years, recurrent expenditure growth would have to be controlled more rigorously than hitherto in order to generate positive central government savings.

As a part of the effort to control recurrent expenditures, the authorities should plan additional cuts in subsidies in the years following 1984, Mr. Erb commented. The interest rate and exchange rate policies apparently were being implemented flexibly, but he agreed with the staff that the authorities would have to keep the interest rate structure under close review, particularly in the light of the projected increases in the rate of inflation. Reducing the fiscal deficit seemed to be the most appropriate way to bring interest rates down.

The relatively detailed medium-term analysis in the staff reports was useful, Mr. Erb said. It clearly showed that a stronger adjustment effort would be needed in the future. The overall balance of payments was projected to be in surplus in 1984/85, but that estimate excluded repurchases from the Fund and assumed that the level of reserves would be equivalent to roughly three weeks of imports at the end of the current fiscal year. Because the economy would probably experience some deterioration in the external current and capital accounts, it would be prudent for the Government to increase reserves. A substantial increase in the overall external balance would be necessary if the authorities were to be in a position to make repurchases from the Fund in the period 1984-85.

There were still structural rigidities in the economy, Mr. Erb commented, including extensive price controls and wage rigidities. Removing the rigidities would enable Mauritius to establish the foundation for higher rates of economic growth in the future.

Mr. El-Khouri stated that he supported the proposed decision.

The staff representative from the African Department said that, in principle, an extended arrangement would have been preferable to the successive stand-by arrangements. However, at the beginning of the long adjustment effort, in 1979, the internal and external imbalances had been substantial, and the vulnerability of the economy, which was heavily reliant on sugar exports, suggested that a series of one-year stand-by arrangements would be preferable to an extended arrangement. The structural problems facing the economy had been dealt with in the context of structural adjustment loans from the World Bank. The second such loan was due to be considered by the World Bank Executive Board on December 8, 1983.

The debt service burden would peak in 1984/85, the staff representative noted, and it would decline sharply thereafter. The peaking of the debt service burden was traceable to the Eurocurrency borrowing in the late 1970s and the high interest rates. The debt service burden did not seem to be a cause for concern, particularly as the authorities planned to repay the Eurocurrency loans as quickly as possible.

As speakers had stressed, the level of investment had been declining in real terms in recent years, the staff representative continued. Indeed, some of the expenditure that had been characterized as investment had not actually been used for productive investment; instead, it had been used in the effort to redistribute income and to create employment in the public sector. The authorities, working with the World Bank, had streamlined the investment program and, although the volume of investment had declined, its composition had improved. Given the objective for the overall balance of payments and the need to contain the overall budget deficit, the programmed level of investment was appropriate.

The sugar export tax had recently been raised to the pre-1982 level, the staff representative commented, but that action had been taken against the advice of the staff. The staff had felt that it could go along with the authorities' decision, pending the release of the report by the Sugar Commission. The staff's reluctant agreement had been given in the knowledge that the authorities were taking a hard look at the sugar industry. The flexible management of the exchange rate had gone some way--but not a long way--toward improving the profitability of the sugar industry or, at the least, toward containing losses. The report of the Sugar Commission had been issued but had not been made available to the staff. It was being studied by the Government, and the staff hoped to learn of its contents during the next round of discussions with the authorities.

It was true that real interest rates were high, the staff representative said, but the flexibility of interest rates should be seen as the best means of improving the allocation of resources. There was considerable competition among banks, which tended to prefer to lend to nonpriority sectors, whose loans carried higher interest rates than loans to priority sectors. The staff and the authorities had agreed that flexible interest rates would be the best way to allocate credit among the various sectors. In any event, the staff did not believe that interest rates were excessively high, particularly given the prospective rate of inflation of 9 percent in 1984 and the need to encourage domestic savings and to contain demand.

Both a flexible exchange rate policy and an appropriate wage policy were needed to improve the competitiveness of the economy, the staff representative considered. The flexible exchange rate should yield more positive results for the budget than wage policy. In any event, it was not yet clear to the staff how the new wage policy was to be implemented. The staff hoped that the new policy would result in a reduction in real wages, but that remained to be seen because the trade unions in Mauritius were powerful.

The wage adjustment in the public sector was to take the form of a flat rate increase, the staff representative explained. In the past, public sector employees had been granted merit increases each year in addition to cost of living adjustments. The staff had felt that the Government should fix the maximum rate of increase in the public sector, which would cover merit increases and adjustments to the cost of living; that approach seemed preferable to having two separate increases at the same time. The staff also felt that adjustments in pay should be linked to productivity in the public sector, and that the practice could set the standard for moderation in the private sector. The authorities had indicated that it would be difficult for them to use such an approach because of established contracts with public sector employees, and it was not yet clear to the staff how the authorities planned to implement the wage policy for the public sector. They had in principle accepted the advisability of a single wage adjustment.

The authorities had decided to reduce both the quantitative controls on imports and the scope and rigidity of price controls, the staff representative explained. The reduction of price controls would certainly stimulate production, and the relaxation of import controls on intermediate goods would also help to stimulate production. The question had been raised whether the reduction in lending rates would be sufficient to stimulate investment. Recent press reports indicated that lending rates had fallen by more than 1 percentage point and it was possible that lending rates would decline further. In addition, the differential between the lending and deposit rates, which had widened in the past, had narrowed in recent months. It was difficult to predict the extent to which the interest rate declines would stimulate investment, and the staff would certainly take the matter up with the authorities during the next visit to the country.

The staff agreed that the budget deficit was excessively large, the staff representative commented. Moreover, a further increase in the already large tax burden would be undesirable. A greater effort should be made to reduce current expenditures.

Further adjustment would certainly be needed to improve the prospects for the balance of payments, the staff representative said. The external current account deficit was already the equivalent of some 4-5 percent of GDP, although the staff expected that it would fall to 4 percent in the coming two or three years, and that Mauritius would be able to begin in 1984/85 to reduce its net debt to the Fund. However, given the large repayments of Eurocurrency loans and Fund credit, the level of reserves would continue to be uncomfortably low in the coming period, and the staff would impress on the authorities the need to seek concessional aid to make those repayments. Although the program provided for additional Eurocurrency loans of up to $40 million, the authorities had been reluctant to approach the Eurocurrency market.

The staff expected Mauritius to continue to use Fund resources in the coming two or three years under stand-by arrangements, the staff representative commented.

Mr. Orleans-Lindsay thanked Executive Directors for their useful comments on the economy and the adjustment program.

The Executive Board then turned to the proposed decision, which it approved.

The decision was:

1. Mauritius has consulted with the Fund in accordance with paragraph 11 of the stand-by arrangement for Mauritius (EBS/83/78, Supplement 2, 5/19/83) in order to reach understandings subject to which further purchases may be made by Mauritius under the stand-by arrangement.

2. The letter from the Minister of Finance and the Governor of the Bank of Mauritius of September 30, 1983 shall be annexed to the stand-by arrangement for Mauritius, and the letter of March 21, 1983, attached to the stand-by arrangement, shall be read as supplemented by the annexed letter. Accordingly, paragraphs 2, 4(a), and 4(b) of the stand-by arrangement are amended to read:

"2. Purchases under this stand-by arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 8.25 million until November 14, 1983, SDR 24.75 million until January 14, 1984, SDR 33.0 million until April 14, 1984, and SDR 41.25 million until July 14, 1984."

"4(a) during any period in which:

(i) the limit on total domestic credit described in paragraph 10 of the attached letter dated March 21, 1983, and in paragraph 5 of the annexed letter of September 30, 1983; or

(ii) the limit on net credit by the banking system to Government as described in paragraph 10 of the attached letter dated March 21, 1983, and in paragraph 5 of the annexed letter of September 30, 1983; or

(iii) the limit on contracting, guaranteeing, and drawing down of government and government-guaranteed nonconcessional foreign financing as described in paragraph 10 of the attached letter dated March 21, 1983, and in paragraph 9 of the annexed letter of September 30, 1983,

is not observed; or

4(b) during any period after January 31, 1984, until suitable performance clauses with regard to total bank credit and net credit to the Government, as defined in paragraph 10 of the attached letter dated March 21, 1983, and in paragraph 5 of the annexed letter of September 30, 1983, have been established in consultation with the Fund as contemplated in paragraph 12 of the attached letter dated March 21, 1983 and in paragraph 11 of the annexed letter of September 30, 1983, or if such clauses, having been established, are not observed; or"

Decision No. 7567-(83/162), adopted
November 23, 1983

3. ARGENTINA - EXTERNAL DEBT - REPORT BY MANAGING DIRECTOR

The Chairman said that he had just been informed by a member of the Advisory Committee for Argentina that the banks were moving forward on the release of the $500 million portion of the medium-term loan being negotiated for Argentina. He had told the representative of the Committee that the forward movement was welcome, as the negotiations on the loan had been under way for some time, and the release of the $500 million should pave the way toward both the resumption of discussions with the Argentine authorities on fundamental issues and a more durable relationship between the Fund and the country.

The Executive Directors took note of the Chairman's statement.

APPROVED: March 29, 1984

LEO VAN HOUTVEN
Secretary