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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 82/41

10:00 a.m., April 5, 1982

W. B. Dale, Acting Chairman

Executive Directors	Alternate Executive Directors
	O. Kabbaj
	J. F. Williams, Temporary
A. Buira	M. A. Senior
J. de Groote	H. G. Schneider
	P. D. Peroz, Temporary
R. D. Erb	T. A. Connors, Temporary
	T. Alhaimus
T. Hirao	
	F. A. Tourreilles, Temporary
R. K. Joyce	M. Casey
A. Kafka	J. R. Gabriel-Peña
B. Kharmawan	V. Supinit
	F. Sangare
G. Laske	G. Winkelmann
G. Lovato	C. P. Caranicas
	A. Alfidja
M. Narasimham	
	S. El-Khouri
	D. Pritchett, Temporary
	T. de Vries
A. R. G. Prowse	
	L. Vidvei
	Tai Q.

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

Also Present

African Department: O. B. Makalou, Deputy Director; D. E. Syvrud, P. C. Ugolini. Asian Department: K. A. Al-Eyd, P. Chabrier, S. Kashiwagi. European Department: L. A. Whittome, Counsellor and Director; A. Arimo, E. O. C. Brehmer, J. J. Hauvonen, W. E. Lewis, J. Perejoan-Mustaros, J. R. Wein. Exchange and Trade Relations Department: C. D. Finch, Director; S. Mookerjee, Deputy Director; S. Kanesa-Thasan. Fiscal Affairs Department: N. N. Choudhry, J. R. Modi. Legal Department: G. P. Nicoletopoulos, Director; J. G. Evans, Jr., Deputy General Counsel; G. F. Rea, Deputy General Counsel; B. R. Campbell, Ph. Lachman, S. A. Silard. Middle Eastern Department: E. M. Taha. Research Department: W. C. Hood, Economic Counsellor and Director; K.-Y. Chu, L. U. Ecevit, N. M. Kaibni, E. A. Milne, A. Muttardy, P. Radhakrishnan, B. R. H. S. Rajcoomar. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer; A. M. Al-Samarrie, D. Berthet, H. O. Flinch. Western Hemisphere Department: M. Caiola, J. F. van Houten. Advisors to Executive Directors: S. R. Abiad, E. A. Ajayi, C. J. Batliwalla, C. Bouchard, A. B. Diao, M. A. Janjua, K. V. Jännäri, G. Jauregui, S.-W. Kwon. Assistants to Executive Directors: E. M. Ainley, H. Alaoui-Abdallaoui, L. Barbone, M. J. Callaghan, R. J. J. Costa, M. K. Diallo, J. L. Feito, A. Halevi, P. Kohnert, J. S. Mair, W. Moerke, J. A. K. Munthali, V. K. S. Nair, Y. Okubo, J. G. Pedersen, J. Reddy, J. Schuijer, D. I. S. Shaw, H. Suzuki, P. S. Tjokronegoro, O. Üçer, P. Verly, J. F. Williams, A. Yasseri.

1. NORWAY - 1982 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1982 Article IV consultation with Norway (SM/82/48, 3/5/82). They also had before them a report on recent economic developments in Norway (SM/82/51, 3/17/82).

The staff representative from the European Department remarked that recent information received from the Norwegian authorities showed that in 1981 the current account of the balance of payments had been in surplus to the extent of NKr 13.8 billion instead of the NKr 12.1 billion shown in Appendix II to SM/82/48. Also, largely as a result of the 15 per cent reduction in the price of crude oil in Norway since the end of 1981, the oil tax revenue, which had been estimated to amount to some NKr 100 billion for the four years 1982-85, would be substantially lower. According to newspaper reports, the figure might be as low as NKr 70 billion on a cash basis, but any estimate should be used with great caution in view of the difficulties of forecasting oil revenue.

Mr. Vidvei made the following statement:

> The staff has presented a comprehensive and balanced report for this consultation and I would like to take this opportunity to express my appreciation for their work. On behalf of the Norwegian authorities I would also like to thank the staff for the useful discussions held in Oslo in January.
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> At the outset of 1982 I would characterize the Norwegian economy as fairly well balanced. It is operating at practically full employment. The current external account shows a moderate surplus. The two main areas of concern are at present, first, the high rate of price increases generated by rising costs and a high level of demand, and second, the lack of growth in the economy. These negative features seem to persist in 1982, and might result in a weakening of the labor market. In spite of this the unemployment rate in Norway will remain low by international standards.
>
> The Norwegian economy--as other small open economies--is strongly influenced by the present world recession and the restrictive demand policies pursued by its major trading partners. But, as correctly pointed out by the staff, Norway faces a domestic cost and price problem that has to be solved. After having reduced the inflation rate--as measured by the consumer price index--to 4.8 per cent in 1979 and closed a large part of the "cost gap" in the non-oil export industries that had opened vis-à-vis competitor countries in the years 1974-77, an acceleration in the rate of inflation was registered in the first part of 1980, reflecting higher import costs, pent-up price pressure from the price-freeze period, and adjustments in administered prices. Subsequently, the high rate of inflation was

reinforced by wage and salary increases, rises in administered agricultural prices, and changes from direct to indirect taxes. Thus, the rise in prices has to an increasing extent--as pointed out by the staff--been the result of domestic rather than external factors. From 1980 to 1981 prices on imported consumer goods--as measured in the consumer price index--rose by only 7.4 per cent.

Maintenance of full employment is a priority goal of Norwegian economic policy. This policy has in recent years been based on strong growth in domestic demand and high investments in the development of oil and gas resources. In the first stages, growth of domestic demand was financed from foreign borrowing and subsequently by increased oil revenues. The development of the petroleum resources had certain demand effects upon important sectors of the economy and facilitated restructuring in the direction of growth industries. The result was, all in all, that government future and current revenues from oil taxes were channeled into the domestic economy. An important issue for the Norwegian authorities is now how best to control or limit the effects of the oil sector on the domestic economy to avoid too rapid structural adjustments. The price and cost problem is clearly related to this issue, and the Norwegian authorities attach great importance to the maintenance of the competitive position of Norwegian industries, regarding this as a precondition for maintaining full employment in the future. The need to improve competitiveness of traditional industries has been further emphasized by the recent downward revisions of output from existing oilfields and by the decline in oil prices. Thus, the latest projections indicate that increases in real incomes in the 1980s will have to be based mainly on the expansion of the non-oil sector.

Let me at this point comment briefly on the latest developments in oil prices. The most recent official forecasts for the Norwegian economy were based on a price of $37.50 a barrel in 1982. That was the contract price until February when Statoil (the State Oil Corporation) reduced its price to $36. In early March the price was further reduced to $31-32 a barrel. Based on this dollar price and an exchange rate of NKr 5.75 = $1, there will be no dramatic consequences for the official 1982 estimates. Government revenues for 1982 might be reduced by approximately NKr 3 billion, and the current external account might turn into a small deficit, instead of the small surplus as projected in the most recent official forecasts.

Obviously the medium-term consequences might prove to be more significant. Instead of a moderately increasing trend in oil revenues, one might now see a relatively large drop in government revenues from oil and gas production in 1983, and a leveling off at the 1983 level, or below, for the remaining two years of the long-term program period 1982-85. Needless to say, such a development would have important implications for the Government's financial position and the balance of payments in the years to come. Rough calculations indicate that deficits on the current account of the balance of payments--under certain assumptions--might reach as high as NKr 10 billion in 1983 and 1984. However, too great importance should not be attached to such figures. Nevertheless, they demonstrate the uncertainties and the vulnerability of the economy if it is based too heavily on the petroleum sector.

It is difficult to estimate price and cost developments for 1982, as they will be greatly affected by the result of the income negotiations this spring. The average increase in consumer prices from 1980 to 1981 was 13.6 per cent, the highest rate since 1951. A part of the increase was, however, due to tax adjustments and, corrected for these, the consumer price rise was 11 1/2 per cent. The carryover of price increases from 1981 into 1982 was approximately 3 1/2 per cent, markedly less than last year's. The exceptionally high rise of 3 per cent in consumer prices in January was to a large extent due to increases in indirect taxes. For 1982 one might expect a consumer price rise of about 10 per cent, well above the average rise in consumer prices (forecast at 8 per cent) in the countries that are Norway's most important trading partners.

Measured by changes in relative unit labor costs, there was a slight deterioration in the competitive position of Norwegian industries in 1981. In spite of the fact that the carryover of wage increases at the outset of 1982 (approximately 2 3/4 per cent in manufacturing industry) was only about half as large as the carryover recorded a year earlier, the scope for wage increases in this year's wage settlement is very limited if a further worsening of the competitive position is to be avoided. The Government has revised the former Government's tax proposal in order to prevent bracket-creep from adding to wage demands. At the present stage of income negotiations, however, it is too early to speculate on the outcome. The important iron and metal workers' union has demanded an 11 1/2 per cent increase in wages in 1982 over 1981, while the management side has stated that the increase in wage costs should be limted to 6 1/2-7 per cent to avoid loss of competitiveness. When account is taken of the carryover from 1981 and locally negotiated wage increases, the figures imply that there is little room for wage increases through the negotiations at the national level between the different trade unions and their corresponding employers' associations. The staff's judgment that maintenance of competitiveness in 1982 is unlikely to be achieved is thus difficult to challenge. Still, it is the Government's medium-term objective to improve the competitive position of Norwegian industries. This is seen as an important precondition for the maintenance of full employment. Over the coming years the Government will, through its incomes policy, strive to reduce the need for nominal wage increases. This policy will include tax concessions. There is also a need to improve productivity and counteract the tendency toward segmentation in labor markets, i.e., greater labor mobility is needed.

A tighter fiscal policy, as pointed out by the staff, is in line with the intentions of the Government and also the thrust of the 1982 budget. Thus, the budgetary plans for 1982 are aiming at a reduction from 1981 to 1982 in the government budget deficit, excluding oil revenues, as a percentage of GDP (excluding oil and shipping) and a moderation in the domestic liquidity effect of central government transactions. Due to the latest developments in oil prices and its effects on government revenues, the income tax reductions envisaged in the Government's budgetary plan might have to be spread beyond 1986. This would be in line with the staff's recommendations.

The staff discusses the importance of reducing government support to ailing firms and states its concern that withdrawal of such support might be delayed as a consequence of a possible worsening of the competitive position of traditional industries in 1982. The increase in industrial support in the period 1973-77 was part of an antirecessionary policy adopted in order to bridge a period of weak foreign demand. Since 1977 a real reduction in direct support to the Norwegian industrial sector has taken place, and from 1981 to 1982 the budgetary plans imply even a reduction in nominal terms.

Assessing the degree of government support to industries in various countries is a very complex issue. The economic environment in which the industrial sector is working is shaped by a number of factors. Government support should be seen as a part of the total tax/subsidy system under which firms work. Thus, the net effect of government policy might not be as simple as the support figures themselves imply. If one looks at direct government support to firms in financial difficulties, the figures in Norway are fairly small.

It is the intention of the Government to reduce selective support to enterprises, but there are clearly some conflicting considerations involved, especially in the short term. As some reduction in corporate taxes is contemplated, this could be implemented simultaneously with reductions in selective support. In the shipbuilding sector the scope for reduction of the support is limited in the short run, as long as other countries seem to be maintaining their government support to this sector at a relatively high level. In the longer run, however, increased demand in connection with developments of new oilfields in the North Sea and maintenance work at oilfields should leave room for reducing support to the shipbuilding sector. Government support policy in Norway also has very important regional aspects and is often related to the problems created by one-factory towns in remote areas.

A number of new steps have been taken in the monetary policy field during the last few months. The index-linked bond offer in January was very well received by the household sector and was greatly oversubscribed. The amount, NKr 1 billion, corresponds to a reduction of the money stock, broadly defined, by 1/2 of 1 percentage point. A new offer with the same terms will be made in April, but this time the amount might not be limited. The bond investment obligation for banks, insurance companies, and pension funds has been reduced, and interest rates on government bonds have been increased in order to limit the supply of credit to the private sector. On five-year government bonds the interest rate is currently 12.5 per cent. In order to gain better control of the bond market, the guidelines for issuing private bonds have recently been tightened. The rules for conditional loans to banks from the central bank have, moreover, been revised so as to supply less liquidity at a given level of credit expansion. The sectoral regulation of loans from the banks was abolished from the end of March. But total loans from the savings banks are now contained within strict limits by indirect instruments. Furthermore, in order to achieve even more flexibility in the control of savings bank lending through indirect instruments, the Government has proposed that the maximum ratio for their reserve requirement should be raised. The Minister of Finance has asked the credit institutions for their cooperation in restricting the supply of credit through the unregulated market and has said that if this does not prove sufficient, bank guarantees for transactions in this market will be directly controlled.

These steps should make the control of credit expansion more effective than was the case last year. The Government agrees that, in principle, a flexible interest rate policy would be preferable in line with a general reduction of direct regulations in the credit market. In order to achieve this, fiscal policy must be tightened--a process that requires time. Moreover, in the view of the Government, a general increase in the level of interest rates is not appropriate at present. Thus, in its interest rate policy declaration last January, the Government stated that the banks and insurance companies should maintain the present average level of interest rates on loans. Exceptions were made for a few categories of loans where the interest rates are stipulated directly by the authorities and where the rates are particularly low (e.g., house-building loans). These rates were raised by 0.5-1 percentage point.

Before concluding, I would like to state my agreement with the staff's appraisal of exchange rate policy. No change in this policy is considered.

Finally, I think the Government's short- and medium-term economic strategy can be summarized as follows:

- tightening of overall fiscal policy;

- reducing personal and corporate taxes;

- limiting the growth of public expenditure, in particular of transfer payments;

- easing the burden that the monetary policy has to carry with the aim to stimulate private investments and productivity growth;

- supplementing fiscal and monetary policies by incomes policy measures; for example, in the form of tax reductions with the aim of influencing income negotiations;

- strengthening policies aiming at improving the functioning of the production sector and at easing structural problems.

Mr. Peroz considered that Norway had been only moderately successful in attaining its broad policy objectives. On the negative side, for instance, costs and prices had not moved as expected, and real GDP had not grown at all in 1981. If the Government wished to achieve its main objectives, which were to improve competitiveness and to maintain a reasonable rate of growth, it would therefore probably have to re-examine some of its earlier priorities and policy choices. However, it would not be reasonable to be pessimistic about the immediate future, not only because the difficulties confronting Norway had to be seen in perspective against the broader international economic situation, but also because Norway enjoyed a number of positive advantages that should make further progress relatively easy.

One of the most favorable aspects of the economic situation in Norway, Mr. Peroz noted, was the absence of any significant constraint on the external account, mainly as a result of the extraction of North Sea oil. Despite a small drop in the volume of oil and gas exports in 1981, the current account surplus had risen to somewhere near 4 per cent of GDP, while external debt had fallen from 44 per cent of GDP two years previously to 25 per cent, and reserves represented 21 weeks' imports, the highest level ever achieved. Domestically, one positive feature was the absence of any serious unemployment; at 2 per cent of the labor force, unemployment in Norway was among the smallest of any industrial country.

The outlook for 1982 and beyond, however, made it doubtful whether Norway would continue to enjoy both a strong external position and full employment, Mr. Peroz commented. In the first place, the small current account surplus still expected for 1981 was likely to turn into a deficit. While the main reason for the deterioration in the external position was naturally the change in the energy sector, there were other factors as well, such as interest payments on previous foreign financial investments, the poor outlook for traditional exports, and rising relative unit labor costs, which seemed likely to become more significant in the years ahead. In the circumstances, it was doubtful whether the present high-employment and industrial policies could be pursued much longer without endangering other essential objectives in the fiscal and monetary field.

For instance, while inflation had fallen somewhat in the second half of 1981, the 13.6 per cent increase in prices registered in 1981 had taken place despite a six-month price freeze, Mr. Peroz observed. In the circumstances, any relaxation of fiscal policy appeared undesirable, particularly in view of the rather close connection between fiscal deficit and monetary expansion in Norway. In view of the high degree of automaticity of public expenditure and the authorities' commitment to reduce income taxes further in the next two years, it seemed likely that fiscal policy would remain expansionary in 1982 and beyond. In those circumstances, closer attention to the longer-term consequences on the adjustment process of supporting ailing industries and maintaining full employment through various financial schemes seemed justified. In that respect, the comments made by the staff on fiscal policy and the need to maintain cost competitiveness seemed most appropriate, especially as the forthcoming period of relative stagnation in economic growth seemed likely to put additional pressure on the budget at a time when the current account was expected to weaken substantially. The declaration by the new Government that improved competitiveness and the withdrawal of financial support to ailing industries was a precondition for high employment and growth had considerable significance.

Finally, Mr. Peroz commended the authorities for their consistently substantial efforts in connection with official assistance. For the first time, Norway's budgeted assistance would exceed 1 per cent of GNP in 1982--an increase of about 25 per cent in real terms over the level of two years previously. Such achievements reflected more than a comfortable external position; he hoped that the attitude and approach to the difficult problems of the developing world adopted by Norway would serve as an example to many others.

Mr. Winkelmann recalled that when the Executive Directors had discussed the economic situation in Norway in September 1980 (EBM/80/133) they had been quite optimistic. They had felt that, with some exchange rate adjustment and a decline in the rate of increase of prices, the rapidly increasing oil revenues should enable most long-term problems to be overcome, it being understood that there were no real short-term problems. At present, however, there clearly were some short-term problems for the authorities to tackle. The expansion of the oil industry seemed to have shifted fiscal policy in a direction that was not entirely satisfactory, since some of the profits from oil were being used to provide finance for those sectors--amounting to 85 per cent of GDP--that were receiving assistance from the Government under the policy known as "support to ailing industries." Although it might be true, as Mr. Vidvei had said, that other countries used government funds to support ailing industries even more than Norway, such a policy did not help to bring about the needed structural changes or promote adjustment, even if they did help to achieve the goal of full employment. If the Norwegian economy were completely closed, there was no reason why the policy should not be successful; but in an economy as open as that of Norway it seemed very doubtful that the outcome would be desirable. A country that pursued full employment objectives in the face of pressing demands for higher wages without insisting on an appropriate level of productivity was likely to find itself quite uncompetitive in markets abroad, and even with imported goods at home.

He understood the argument that it was better to subsidize certain sectors of industry rather than pay higher unemployment benefits, as was done in other countries, Mr. Winkelmann stated. Nevertheless, in the long run the only outcome was a fall in productivity and a decline in competitiveness. He therefore wondered how much longer the Norwegian authorities could continue with their present policies.

As he understood it, Mr. Winkelmann went on, the Government intended to maintain a tighter budget and to provide less help to ailing industries; unfortunately, the surplus from the oil sector seemed likely to decline in the near future, thus creating difficulties not only for the domestic budget but also perhaps for the balance of payments. The present aim of the Government was to promote mobility and offer incentives by lowering direct taxes, thus raising the willingness to work of both entrepreneurs and employees. It was difficult to carry out such a policy at a time of falling revenues; the budget deficit seemed likely to rise to some 7 per cent of GDP and monetary policy would remain ineffective. He therefore agreed with the staff that the authorities should consider postponing planned tax reductions until 1985. If it were possible to persuade the trade unions to accept the tax reductions in compensation for foregoing higher income, it would be easier to avoid cost-push price increases and thus reduce the rate of inflation. However, when there had been a tax reduction in FY 1980/81, the trade unions ignored it and there had been both demand-pull and cost-push inflation at the same time. In the light of past experience, the staff was pessimistic on the point, and Mr. Vidvei's remarks did not give much ground for hoping that the trade unions would accept a tax reduction as compensation for foregoing increased earnings. In the circumstances, he wondered how long the Government would be able to maintain its full employment policy.

One way of tackling the problem, Mr. Winkelmann considered, was to try to reduce the extent to which wages were indexed. If it was impossible to reduce indexation straight away--and he agreed with the staff that it would not be desirable to change the exchange rate in order to bring the domestic economy more closely in line with the outside world--the only approach seemed to be to restructure the domestic economy rather than to act on the external side.

If the current account of the balance of payments were to be in deficit for the next few years, it could easily be financed, Mr. Winkelmann observed. Nevertheless, Norway had accumulated quite a substantial foreign debt over time, and if the current account were to run into deficit, it would surely be an indication that more domestic adjustment was required.

Norway's monetary policy seemed to be closely dependent on the use made of fiscal policy, Mr. Winkelmann noted, but it was still desirable to encourage the Government to make more effective use of its open market policy and interest rate policy than it had been doing recently. The structural problems were liable to become more severe as earnings from the oil sector declined, and it was essential to persuade the trade unions to take part in containing domestic cost pressures and increasing mobility. With the assistance of the trade unions, in the next three or four years it should be possible to make Norwegian industry competitive once again and to return to the policy of full employment. He hoped that the authorities would be able to achieve national consensus for a better control of the domestic budget, for a more effective use of monetary policy, and for efforts to restructure the economy while keeping Norway open to the outside world.

Mr. de Vries commented that Norway had found itself to be an unexpected producer of oil, and that the volatility in oil prices had brought with it difficulties that the authorities had not expected to have to face. Mr. Vidvei, like many others, tended to project the present into the future. When oil prices were falling, it was natural to assume that they would continue to fall. What was happening in the oil sector was what would happen in any industry in which a cartel played a major part, meaning that when prices were kept artificially high substitutes became available. Without in any way trying to predict what the future price of oil would be, the international oil market might well come to resemble the structure of markets for agricultural produce. A number of countries had made heavy investments in oil exploration in the recent past. If the price of oil fell, the countries in question were unlikely to abandon their investment. There were therefore likely to be a number of national oil markets, just as there were national agricultural markets, together with an international market in which the surpluses would be sold or in which shortages in meeting demand would be met.

The safest assumption for the Norwegian authorities for the long term would be that oil prices would remain extremely volatile, and perhaps the demand for oil as well, Mr. de Vries observed. A reasonable deduction from such an assumption would be that the Norwegian authorities should try to isolate the traditional sectors from the vagaries of the oil sector. In principle, the Government could achieve its objective by accumulating resources at a time of heavy demand for oil and high prices and by using those resources at times of falling prices and falling demand for oil. The aim should be to avoid having the exchange rate and budget policies influenced too greatly by what happened in the oil sector. The Norwegian authorities had therefore been acting quite correctly. They had been trying to maintain full employment irrespective of what happened in the oil industry. Indeed, he would like to see a still greater effort to separate the traditional economy from the volatile movements of the oil sector. Consequently, he agreed with what the Norwegian authorities had been doing in the domestic sector, and he urged them to implement the policies summarized by Mr. Vidvei.

He was, however, rather less certain that there was no need for improvement in the monetary policies followed by the authorities, Mr. de Vries stated. As he understood it, there was considerable rigidity in interest rates in the bond market. There was no great benefit in setting an interest rate for a particular group of bonds and making that interest rate a main objective of policy. Flexible interest rates should be used as a means of achieving more important policy objectives.

As to the exchange rate, Mr. de Vries noted that the Norwegian authorities had placed great emphasis on maintaining competitiveness in the traditional sectors. While it was important that those sectors should be modernized, the exchange rate should be set in such a way as to keep the traditional sectors alive; it should not be influenced by sudden fluctuations in the oil sector. He understood that it would be difficult to follow the policy that he had tried to outline; if resources flowed in from abroad, there was a great temptation to spend them piecemeal to meet local requirements. Nevertheless, a policy of keeping the traditional sector separate from the vagaries of the oil sector ought to be pursued, even if his own country had failed to do so successfully.

Mr. Pritchett observed that Norway was facing the classical dilemma of countries experiencing rapid increases in production in a major commodity sector. Norway had tried to take advantage of the large revenue gains from oil while restraining structural adjustment from taking place, largely on social grounds. He understood the inherent conflict that was bound to arise, and would basically comment instead on some other aspects of the staff report.

On structural matters, Mr. Pritchett remarked, the authorities clearly envisaged withdrawing financial support from ailing industries. Yet, in 1981 financial assistance in the form of loans and grants amounted to NKr 3 billion. Regarding structural aspects, two issues seemed important. First, it was not at all clear how the withdrawal of such support could be undertaken without coming into conflict with regional policy objectives. Second, the Norwegian representatives had told the Fund staff that there were widespread constraints on overtime work in Norway and on efforts to supplement family income through extra work. Such policy impediments might over time have deleterious effects on productivity.

Taking up the macroeconomic policies followed by the Norwegian authorities, Mr. Pritchett observed that since the mid-1970s the Norwegian economy had been running at full capacity. Indeed, during the period 1974-79 the Norwegian people were demanding more than they were producing by a substantial amount. Consequently, unemployment had hovered around

2 per cent since the mid-1970s. He hoped that productivity would not deteriorate over the next few years, given the possibility of a significant shift toward more restrained macroeconomic policies.

Concerning inflation, it was worth recalling that a price freeze had been imposed twice in the past two years and that there had been major wage agreements in April 1980, Mr. Pritchett said. Nevertheless, inflation had risen from 8.1 per cent for the period 1974-78 to 12.7 per cent in 1981. The price rise would have been much larger had it not been for the comparative strength of the krone, which had made imports cheaper. In those circumstances, he had two questions for the staff. First, unless action were taken, how long would it take the inflation rate to become quite serious? Second, was there any way of knowing whether price levels were today higher or lower than they would have been if there had been no price controls?

Another major issue was international competitiveness, Mr. Pritchett continued. As oil exports had risen rapidly and were expected to remain high for a long time, it was not surprising that the krone had been strong and that other Norwegian industries had tended to suffer. Since 1977, unit labor costs in domestic manufacturing had declined compared with the foreign competition; in contrast, prices of domestically produced import-competing goods had risen compared to those of foreign goods. Perhaps not only fiscal constraint, as suggested by the staff, but also monetary restraint might be needed to enhance international competitiveness. Finally, he commended wholeheartedly the Norwegian authorities for their performance in official development assistance, which for 1982 was to amount to 1.05 per cent of estimated GNP, most of it in the form of grants.

Mr. Caranicas commented that Norway's economic performance during the past two years could be characterized as mixed. Nevertheless, there was one continuing characteristic that was clearly worthy of note--the very low level of unemployment. By comparison with the rest of the world the Norwegian record was quite extraordinary. The authorities had not been disturbed by the debate taking place elsewhere as to whether the first aim of policy should be to bring down the rate of inflation or to tackle unemployment; in Norway the maintenance of full employment had had priority. Helped by successful adjustment policies in the 1970s, a strong recovery of foreign demand, and a sharp increase in oil prices, the authorities had been able to maintain full employment while the economy had been growing at a rate of 3.5 per cent.

At the same time, Mr. Caranicas went on, inflation had begun to accelerate once again. In most parts of the world, price and wage freezes had been unsuccessful; in Norway the price freeze itself had been successful but the authorities had not taken full advantage of the breathing space it offered. In particular, fiscal policy had remained too expansionary. During 1981, at 13.6 per cent, the average increase in consumer prices was substantially above the 10.5 per cent for the OECD area as a whole. Moreover, there was no difference of view between Mr. Vidvei and the staff to the effect that the rise in prices could be attributed more to domestic factors than to external ones. It was not expected that fiscal policy would become any less expansionary than it had been, and domestic cost movements might be adversely influenced by the lifting of a temporary price freeze that had been in force from August 1981 to the end of the year.

To preserve full employment, the authorities hoped to improve competitiveness and withdraw support from the so-called ailing industries, Mr. Caranicas said. Among the main elements in the strategy for the program was the moderation of wage increases compatible with an improvement of the relative cost position. Unfortunately, prospects for moderating wage increases and improving the relative cost position in 1982 did not look favorable. It seemed unlikely that wage increases in 1982 would be low enough to maintain competitiveness. The unions had apparently determined to maintain the real disposable income of their members by obtaining higher wage increases in the tight labor market, despite the Government's appeal for moderation and wage restraint. But further loss of competitiveness did not seem to warrant any particular action, and the authorities were right not to consider devaluing the krone.

No one would disagree with the affirmation that use of fiscal measures to support ailing industries should be avoided, Mr. Caranicas stated. In Norway in particular, subsidizing ailing industrial firms placed too heavy a burden on branches of industry that were still competitive. The arguments against subsidizing ailing industries were well known. Nevertheless, although the general argument was irrefutable, he agreed with Mr. Vidvei that in Norway the issue was very complex. In particular there was the special case of one-factory towns in remote areas. He was at least encouraged by the announced intention of the authorities to reduce collective support to industrial enterprises on the grounds that cutting back on subsidies to ailing industries would help to stimulate structural adjustment and industrial productivity.

Structural adjustment of the economy could not be avoided in the long run, Mr. Caranicas considered. The loss of market shares, lack of capacity, and sluggishness of exports would inevitably lead to the disappearance of the current external surplus. While virtually all industrial countries would find their current account positions strengthened by a decline in oil prices, Norway seemed to be heading for a current account deficit. The present OPEC price of $32-34 a barrel might have to be reduced further; indeed, if the OPEC pricing formula based on changes in economic growth, inflation, and exchange rates in industrial countries had been applied since 1974, the effective OPEC price today would be about $28 a barrel. Oil prices would probably continue to fall in the near future. There were therefore likely to be significantly higher deficits on current account of the balance of payments in 1983 and 1984. With such vulnerability to fluctuations in the world trade in oil, he wondered how the authorities intended to plan repayment of Norway's official external foreign debt and the debt of the oil sector.

Mr. Connors observed that Norway was fortunate to possess abundant oil wealth, although that wealth seemed likely to complicate economic management in certain areas. One problem that the authorities had faced was in deciding upon appropriate action toward the traditional industries, given the surge in oil and gas exports and the sharp improvement in Norway's terms of trade. Certain firms and industries seemed to be no longer viable in the changed circumstances. The previous Government had chosen to give financial assistance to some affected industries, primarily to maintain employment. However, while such support did ease potential short-run employment problems, it would only delay needed adjustment, especially in the labor market. Like the staff and previous speakers, he would encourage the authorities to continue implementing their policy of withdrawing government support from ailing industries; otherwise, there would be no growth in the industries that could provide a lasting improvement in employment. At the same time, he realized that withdrawing support from traditional industries could be difficult both politically and socially.

Fiscal policy seemed to have been complicated by the increased tax revenues derived from the oil sector, Mr. Connors observed. In the circumstances, the Government had undertaken the responsibility of providing substantial employment support and of improving social benefits. The result had been an overexpansionary fiscal policy in 1980 and 1981. With the Government's desire to support employment, fiscal policy contributed to a tightness in the labor market and excessive wage awards that would make Norwegian industries less competitive.

He endorsed the Norwegian authorities' efforts to reduce the tax burden, Mr. Connors went on. It would seem prudent to leave the private sector with relatively more resources to allocate instead of transferring them to the Government, since the Government might be unable to resist pressures not to curtail expenditures in inefficient industries and on inefficient employment support.

It seemed clear that the implementation of monetary policy would be facilitated by allowing for more flexibility in interest rates and relying less on direct controls, Mr. Connors stated. The continued overshooting of monetary targets appeared to be caused by the authorities' inability to conduct open market operations because of interest rate rigidities.

He had one question about Norway's exchange rate policy, Mr. Connors stated. The staff had mentioned that it agreed with the Norwegian authorities that a depreciation of the krone was not warranted. However, it would be interesting to know the staff's views about the desirability of appreciating the Norwegian krone if external accounts remained in surplus. While it was true that an appreciation of the krone would have an adverse effect on ailing firms, the authorities' contention that appreciation would adversely affect viable firms seemed questionable. After all, if firms were not viable at an exchange rate largely determined by market forces, it might be better not to induce those firms to expand by adopting an undervalued exchange rate.

Mr. Prowse said that he was largely in agreement with the staff analysis of a rather complex economy. The problems that Executive Directors had been addressing were those of prosperity. They had been handled well and the Norwegian authorities had recognized that they were perhaps at some watershed in the conduct of policy. Any country whose prosperity had been geared to reliance on a major export commodity would understand the difficulties caused by the volatility not only of the price of that commodity but also of exchange rates in general.

On the question of the exchange rate for Norway, Mr. Prowse remarked that he agreed with the staff analysis. Executive Directors ought perhaps to emphasize that where loss of competitiveness arose from wage push, devaluation of the exchange rate would not provide a solution. If there were to be a devaluation, it should be preceded by appropriate domestic policies. The potential problem with the external account arose significantly from the wage side, as did the threat to full employment. Those concerned in wage negotiations would have to realize that real wages must reflect the availability of resources for consumption and investment; it was clear that in Norway external developments had affected the availability of real resources in the economy. Mr. Winkelmann had made pertinent remarks on that point and he wondered how an incomes policy would contribute to resolving the problem. It would be helpful if Mr. Vidvei would elaborate on the incomes policy pursued by the Norwegian authorities and say what further contributions they expected it to produce. It would not be enough to hope that tax reductions would lead to a softening of wage demands.

He had been rather disturbed by Mr. Vidvei's remarks about fiscal policy, Mr. Prowse stated. According to Mr. Vidvei, a tightening of overall fiscal policy would be accompanied by a reduction of personal and corporate taxes, while limiting the growth of public expenditure. He was rather doubtful whether such actions could be called a tightening of fiscal policy, and he agreed with what the staff had said on page 12 of SM/82/48. He would be grateful if Mr. Vidvei could give some assurance that the authorities were contemplating a tightening in the ordinary sense. On monetary policy, he agreed very much with what Mr. Connors had said; in addition he inquired why the Norwegian authorities had decided to introduce indexed bonds. He wondered whether the bonds were to be issued only temporarily, or whether they were to become a permanent feature of monetary operations in Norway.

Finally, Mr. Prowse asked for observations by Mr. Vidvei and the staff on the price freeze in Norway. The economy was relatively highly controlled and there was considerable government intervention. It would be interesting to know whether the authorities were satisfied with the effects of the price freeze, and whether they expected to repeat it in the future. Nevertheless, the Norwegian economy was an affluent one, and there was no reason to expect that the present problems would not be overcome.

Mr. Sangare observed that the Norwegian economy had slipped into near stagnation in 1981, with real GDP growing by only 0.7 per cent, compared with 5.1 per cent in 1979 and 3.9 per cent in 1980. Nevertheless, unemployment had remained low at 2 per cent, while the current account of the balance of payments had been in surplus for a second consecutive year. In the meantime, however, the rate of inflation appeared to have increased from 4.8 per cent in 1979 and 10.9 per cent in 1980 to 13.6 per cent in 1981. The inflationary pressures appeared to have originated at least in part from wage increases, and as most of Norway's trading partners had been experiencing some moderation in price rises, the competitiveness of traditional exports had been affected. Public sector operations had also contributed to the resurgence of inflation. While the public accounts had been in surplus in 1980-81, if oil revenues were excluded public expenditure would be seen to have placed the budget in deficit.

The expansion of the oil industry had affected the performance of the non-oil sector, despite the precautions taken by the authorities, Mr. Sangare considered. Moreover, the authorities had been less successful in restructuring the non-oil sector and making the traditional export sectors more competitive. Fiscal support had been used to maintain full employment and achieve internal regional balance. He understood that the authorities intended gradually to remove support from ailing industries, and the proposed tax incentives were to be welcomed as a means of encouraging investment.

In the energy sector, he welcomed the stance taken by the authorities to encourage the efficient use of resources through the pricing mechanism, Mr. Sangare observed. The system of charging long-run marginal costs for hydroelectric power and the world market price for oil and gas was an appropriate procedure. Nevertheless, the authorities were encountering difficulties in reducing the rate of inflation, perhaps in part because of the indexation clauses in wage settlements and the tight labor market. In such circumstances, the authorities could of course only exercise moral suasion.

While fiscal policy had reasonably been used to support employment and attain internal regional balance, Mr. Sangare went on, the expansionary impact had made the conduct of monetary policy, aimed at containing inflationary pressures, rather difficult. The intended figures for bank lending had been exceeded during 1980-81, and the authorities had raised reserve ratios and adopted other measures to influence bank liquidity. The decision to make government bonds more attractive by increasing the yield was welcome. The Norges Bank had also taken action to control aggregate domestic liquidity supply. He commended the Norwegian authorities for their attitude toward official development assistance, despite a stagnating economy. In 1980 the authorities had provided 0.85 per cent of GNP, and in 1982 they intended to offer 1.05 per cent. A number of countries in his constituency were beneficiaries of Norwegian aid, which was not tied to procurement from the donor country. Norwegian aid was a genuine manifestation of international solidarity that deserved full appreciation.

Mr. Narasimham commended the Norwegian authorities for having resisted the temptation to cut back on aid, despite the objective of tightening fiscal policy. It was most commendable that the authorities intended to raise their aid commitment to over 1 per cent of GDP. Moreover, the quality of Norwegian aid had been among the best, not only in the sense that nearly all Norwegian aid was in the form of grants, but also in the sense of providing a good balance between bilateral and multilateral aid, most of it concentrated on low-income countries.

Mr. Joyce commended the Norwegian authorities for the economic performance they had achieved. It was true that there had recently been some falling off from the successes of 1978 and 1979, that the rate of inflation had risen to some extent in 1980 and again in 1981, and that there had been a reduction in the relative competitiveness of the export sector. It might well be that those shortcomings had been brought on by the adoption of an overexpansionary fiscal policy within the past two years or so. Nevertheless, the Norwegian authorities deserved congratulations for their performance in very difficult circumstances.

The authorities, Mr. Joyce noted, were determined to insulate the traditional sectors as far as possible from developments in the oil industry, with a view to maintaining employment at the highest possible level. However, the protection of ailing industries and the adoption of other measures to encourage employment had led to a slowing down in the adjustment process by inhibiting shifts of labor and capital. The desire of the authorities to cushion the impact of external changes and to avoid the exacerbation of regional problems was very understandable. Nevertheless, it was important to be clear about the circumstances in which a country should attempt to insulate its traditional economy from the vagaries of a new and modern sector that might have taken the country rather by surprise. Attempts to maintain the traditional economy in isolation were easier to justify if the nontraditional sector was expected to exist only temporarily. It might well be that the Norwegian authorities had considered the energy sector to be in that category; however, it now seemed likely that Norway would continue to remain a major energy producer for some time to come.

It was extremely difficult to predict the future course of prices in the oil industry, Mr. Joyce continued, and it was clear that that uncertainty had affected the decision of the Norwegian authorities with respect to the pace of development of the oil industry. It must also have affected their decision as to the extent to which the adjustment process should be allowed to continue. It seemed important that if countries did decide to protect their traditional sectors, they should not run counter to the adjustment process further than was absolutely necessary. In Norway, the policies, while they had been successful in achieving some of the Government's social objectives, had been less successful in other directions. The support of ailing industries had undoubtedly inhibited structural change and reduced the growth of productivity by maintaining employment in weaker enterprises. Moreover, the tax and transfer systems, characterized by high marginal rates and generous social benefits, had undoubtedly reduced the incentive to work. He therefore supported the actions of the new Norwegian Administration in tightening overall fiscal policy and depending upon other measures, such as incomes policy and improvements in productivity, in trying to achieve the structural changes that would have to occur if Norway was to remain competitive in the medium and long term. Finally, like Mr. Prowse, he wondered how a reduction in personal and corporation taxes, together with a limiting of the growth of public expenditures, could be considered as constituting a tightening of overall fiscal policy.

Mr. Tai stated that he was impressed by Norway's economic achievements, and particularly by the low rate of unemployment and the high rate of official development assistance. It would be interesting to know how Norway could be so successful with its policies despite the unfavorable world economic environment. There must be some other factor beside the revenues from North Sea oil that had contributed to the success. He would be grateful if the staff or Mr. Vidvei would comment on his point.

Mr. de Vries said that he agreed with Mr. Joyce that ailing industries were a problem; it was the duty of governments to see that ailing industries were replaced as rapidly as possible by vigorous and competitive industries. He would rely rather less on subsidies and rather more on an exchange rate policy geared to the non-oil sector in Norway, not only to shield the non-oil sector from the effects of the oil sector, but also to make it adjust to the normal changes that a country had to undergo. However, in the long run it was impossible for a country to ignore the large receipts that it obtained from exporting oil. In Norway, the problem of oil receipts had been to some extent alleviated by the need to repay the large foreign loans that had been required to initiate production. The problem of excess resources was therefore less visible in Norway than elsewhere.

In dealing with the vagaries of the oil sector, Mr. de Vries continued, it would be necessary to consider a period of 10 years or more. He doubted, for instance, whether it would have been wise for Norway fully to adjust its non-oil sector to the sudden inflow of resources from the North Sea oil. It would be quite unreasonable to expect Norway to abandon its manufacturing industry, its fisheries, and its agriculture in order to become an oil producer, only to find that it was in difficulty when the oil was exhausted, or the price fell, or countries discovered an alternative to oil. It would not disturb him if for a period of 25 years or so Norway had a current account surplus; it could always invest savings in the rest of the world which was particularly short of savings, while keeping its basic structure intact. Mr. Finaish often drew the attention of Executive Directors to the difficulty that less developed oil producing countries experienced in starting development and to the extent to which it became destructive for other economic sectors and for society to be dependent entirely on oil revenues. In Norway, where there was fortunately a well-developed non-oil sector, he saw no reason why that sector should disappear even over a quarter of a century or so, especially when the rest of the world could well use scarce savings.

The point he had been making, Mr. de Vries conceded, was not different from the advice the Fund had been giving for many years to countries that were major exporters of one particular raw material. That advice had been in essence not to consume all the revenue of the export commodity at a time when prices were high because there would inevitably come a time when prices fell. The fluctuations in the oil industry made the swing more difficult to handle, but the policy implications for a country like Norway were not very different.

Mr. de Groote considered the consultation to be particularly interesting, if only because it raised the whole question of the role of the exchange rate and the criteria for exchange rate determination. There were two possible ways of viewing the situation: either one could say that the country had a balance of payments surplus and therefore that it should appreciate the exchange rate; or one could say that it should maintain the exchange rate at such a level that sectors of the economy that would not otherwise have remained competitive would be enabled to continue to export. As he understood it, the staff was correct in supporting the Norwegian authorities for having adopted a very flexible course and for having taken into account its traditional sectors that would not have remained competitive if the exchange rate had not been correctly adjusted. Such an adjustment was a fundamental option available to any member. The Fund should certainly not object to Norway's action, and there were certainly other comparable cases.

Another interesting feature of the Norwegian economy was that it revealed in an extreme form the difference between imbalances between various regions within a country, and the competitiveness of the country as a whole vis-à-vis the rest of the world, Mr. de Groote considered. Looked at differently, it was perhaps paradoxical that while a fall in the price of oil would be welcome in general terms, the consequent reduction in output might have a very perverse effect on the situation in Norway. It seemed most unlikely that a reduction in the output of oil and a fall in the world price of oil would alleviate Norway's problems, and that was one of the most disquieting features of the current situation. Norway was engaged in long-term investment in the oil sector and would have to continue those investments until somewhere in the twenty-first century. At the same time, it was heavily indebted for past investments. The likely outcome was the constitution of an enclave economy with the enclave absorbing ever-increasing contributions from the Government, while income resulting from the exploitation of the oil itself was likely to diminish. That particular feature of the situation was important because it meant that the policy choices open to the Norwegian authorities would become more difficult as time passed, especially in connection with demand management and fiscal policies. He would therefore strongly agree with his colleagues who had recommended special caution in those two fields.

Mr. Erb observed that one of the weaknesses of the national income accounting system had always been the treatment of a depletable resource. In most countries, where the depletable resource only contributed a small portion of the whole economy, there was no great difficulty; but where the sale of a depletable resource made up a large part of gross national product the situation was more difficult. An alternative way of treating the sale of oil would be to consider the value-added portion of the price per barrel, including a normal profit for the oil industry, as an income flow, and to treat the remainder as the sale of an asset. In that case, he would show the sale of the asset in the capital accounts and not within the current account. The proceeds of the portion that was considered an asset could be invested abroad, either to accumulate foreign assets or to reduce external debt.

Mr. Pritchett, in light of the focus on fiscal policy, commented that he was rather surprised that Executive Directors had not concentrated more on the monetary policy of Norway, and what the authorities intended to do in the future. He would be grateful for clarification of what Mr. Vidvei had meant by stating that the Government's short- and medium-term economic strategy could be summarized, in part, as easing the burden that monetary policy had to carry, with the aim of stimulating private investments and productivity growth.

The staff representative from the European Department, replying to questions, noted that there had been a number of comments on the effectiveness of incomes policy, and on the link between income tax reductions and wage determination. The staff had been rather dubious whether the trade unions would respond to tax reductions, but in the recent past there had been some factors that might lead to more moderate wage settlements, including the reduction in oil prices. Moreover, the Prime Minister had been talking to foreign oil firms and inviting them to exercise wage restraint. Present wage demands were clearly higher than would be justified if maintaining competitiveness was a main consideration. In the past there had been short-term successes with incomes policy; in 1980, for instance, the Government had been able to moderate contractual wage increases. Unfortunately, the tightness of the labor market thereafter had made it impossible to keep to the agreed limit on wage drift.

On the question of flexibility in interest rate policy, the staff representative explained that among bond rates it was only government bond yields that were fixed. The private bond yield had been largely determined by the market after the liberalization of most of the private bond market in October 1980. However, the investment obligation for financial institutions had kept the rate level, even for private bonds, unduly low. The Government had recently taken action to bring the yield on government bonds into line with that on private bonds, so that government bonds would no longer be crowded out by private bonds.

A number of speakers had raised questions about Norway's structural policies, the staff representative recalled. The staff report had made it clear that the withdrawal of aid to ailing industries would not take place in remote areas where there was no alternative employment. Naturally, such a policy inhibited the achievement of greater mobility of labor and the modernization of industry.

Taking up questions about the effectiveness of price control and the inflation rate in Norway, the staff representative remarked that, in the short run price control probably did have an influence; in years like 1980, for instance, the Government had used price control to keep down any increases in price resulting from a rise in profit margins. In the longer run, however, it was doubtful whether such policies were effective, as had been confirmed in studies by the Norges Bank. Another aspect of the matter had been raised by Mr. Pritchett, who had inquired how long it would be before the increase in the inflation rate became serious. That would depend crucially on the outcome of the wage negotiations. While that outcome and thereby the cost pressure on prices were difficult to predict, there might be some moderating effect from the reduction of world oil prices. At present, however, it was quite impossible to indicate a time by which the rate of inflation would begin to slow down.

The authorities intended to repay their foreign debt on schedule, the staff representative explained. It was difficult to make forecasts about debt repayments by the oil sector in view of the recent reduction in price. Since it did seem likely that in the next three years there would be an increase in oil sector investment, the likely outcome would be an increase in the foreign indebtedness of the oil sector. As to whether Norway would be adversely affected by a price lower than $31 a barrel, his own feeling was that it would be profitable for Norway to produce oil even if the price fell to $28 a barrel as suggested by the OPEC pricing formula based on economic growth, exchange rates, and inflation in industrial countries. The cost of producing a barrel of oil in Norway was unofficially estimated at about $22, naturally depending on the depth of the area in the North Sea where the oil was extracted.

An Executive Director had inquired whether the staff considered that the exchange rate for the Norwegian krone would be appropriate if the current account remained in surplus, the staff representative recalled. At the moment the current account could well go into deficit. Even if it did not, it seemed unlikely that the exchange rate would appreciate if only because Norway had a relatively large foreign debt to repay. Moreover, an appreciation would depend very much on the relative inflation rate vis-à-vis Norway's trading partners. If the inflation rate was higher abroad than in Norway, there might be some reason to appreciate the rate in terms of the basket. However, the competitive position had not been very strong for traditional Norwegian industries and the Norwegian authorities had said that in those circumstances they did not wish to use the exchange rate to moderate domestic prices.

In reply to the question why the Government had introduced indexed savings bonds in early 1982, the staff representative said that the intention had been to skim off liquidity and not to finance the Government's accounts. The amount of the first issue had been relatively small, in the neighborhood of NKr 1 billion, and the purpose was to neutralize liquidity at a time when the price freeze ended in January 1982. A further issue of index-linked savings bonds had been proposed for the spring of 1982.

Finally, the staff representative from the European Department mentioned in reply to Mr. Tai that one of the reasons why the authorities had kept unemployment low and foreign aid high was the widespread pronounced feeling for social objectives in Norway, although Norway's ore wealth also helped achieve those aims.

Mr. Vidvei stated that he appreciated the thoughtful comments made by Executive Directors; he would certainly convey them to his authorities. The comments with a critical edge to them were particularly welcomed by the Ministry of Finance and by the Norges Bank; the views expressed by the Fund often helped to repel attacks on a well-balanced economic policy.

One or two of the problems confronting Norway were of interest to the Fund as having international aspects to them, Mr. Vidvei considered. However, before commenting on the problems themselves, it was essential to explain the objectives to which the Norwegian authorities attached fundamental importance. The first was full employment. Unemployment was looked upon not only as the worst form of economic waste, but also as having many unfortunate effects on those capable of working. Second, irrespective of political party, the aim of the Government was to maintain a socially secure society, meaning one in which those who had accidentally lost the ability to support themselves--for instance, by becoming unemployed--should not be left without the means to start again on a new career. Third, there was relatively broad agreement that the population should remain dispersed throughout the country. Fourth, there was general agreement on the desirability of an even distribution of income, equal opportunities for education, health care for all, and the like. In those circumstances, incomes policy in the broad sense of the term was bound to have a major role in the design of any economic policy. It would thus have a strong impact on the budgets of both the Central Government and the local authorities, again regardless of the party in power. Since 1973 Norway had managed to avoid unemployment while preventing inflation from being more rapid than the average for the OECD countries. The reverse side of the coin was the weakening of competitiveness throughout the period.

The main issue at the present moment was therefore to prevent a weakening of competitiveness following the outcome of the wage settlements during the spring of 1982, Mr. Vidvei observed. The Ministry of Finance and the Norges Bank were worried, as all such institutions should be, that it would not be possible to maintain full employment unless the competitive position of the country improved. Throughout the 1970s governments had given various sorts of support to so-called ailing industries, and the present authorities in Norway agreed with the Fund that the support should now be reduced. However, there were cases where it would probably be retained. Among them were small towns or settlements built around a single manufacturing plant producing for export; firms that were well organized and had rational production facilities, but that were losing money temporarily because of the present state of some specific market in the world economy. The authorities took the view that it would be only proper to prevent the disintegration of the society attached to such a plant.

The vagaries of the oil industry had little influence on the medium-term policy of the Norwegian authorities, Mr. Vidvei stated. Production was determined on purely technical grounds, and it took between five and ten years to change production capacity. The authorities had therefore to try to prevent so much oil income entering the Norwegian economy that the country would have to change its domestic policy.

Another set of circumstances in which the Government was forced to subsidize ailing industries, Mr. Vidvei went on, was to counter the support given to ailing industries in other countries. For instance, support to the shipbuilding industry would probably be reduced in future years, when it would be possible to use that capacity for construction work in the North Sea. Another group for which the Government provided support was industries hit by fluctuations in exchange rates. Although the value of the Norwegian krone measured in the usual way had been about the same at the end of 1981 as at the beginning, the krone had fallen against the U.S. dollar by 20 per cent between January and August 1981, and then risen until, in December 1981, it was some 11 per cent below the rate that had obtained at the beginning of the year. At the same time, in 1981 as a whole the krone had strengthened by 13 per cent against the Swedish krona, by 11 per cent against the pound sterling, and by 3 per cent against the deutsche mark. Such violent exchange rate movements had created considerable problems for both trade and industry, as they were bound to do in a country like Norway where imports and exports of goods and services were each equal to nearly 50 per cent of the gross domestic product. While in some cases it was possible to cover exchange risks by purchases in the forward markets, the whole operation was expensive. Although some countries had made windfall profits, others were caught in an exchange rate trap, from which there was really no escape. It was rare for exporting companies to have inputs and outputs so that the exchange rate changes balanced out, and it took very long to build up new markets overseas.

What he had been describing was, of course, a worldwide problem for firms and industries with extensive overseas trade, Mr. Vidvei said. The jobs of many thousands of people might be in jeopardy because countries and international economic organizations had not been able to find ways of monitoring exchange rates correctly. Mr. Winkelmann had commented on the fact that the Norwegian authorities were using oil revenues to subsidize ailing industries. He did not believe that the policy was a new one; the country had for long applied funds to assist certain specific areas or districts. The Norwegian authorities had, in his opinion, used that policy to build up an economy with one of the highest average per capita incomes in the world.

As for monetary policy, the authorities were changing to a more market-oriented and more flexible system, and there was widespread political agreement that such a change was desirable, Mr. Vidvei noted. It would, however, take considerable time to train market operators and develop the attitudes that would make the market function correctly. Naturally, it would take time to change the attitude of people with spare resources toward operating in the market. The issue of indexed bonds had in fact been part of an attempt to encourage the public to buy government paper, whereas in the past the only transactions of the sort had been between the Government and the banks. As a further attempt to change monetary policies, the Norwegian authorities would try to avoid rationing credit, as they had hitherto, and allow interest rates to play a more important role.

The most important economic discussion was, however, focused on how incomes policy should work in the future, Mr. Vidvei said. It was stressed that the Government could no longer bear the sort of burden it had accepted in the 1970s in order to maintain full employment. In that connection, the answer to the questions by Executive Directors who had wondered how reducing taxes could be reconciled with a tighter fiscal policy was that the Government intended to reduce the volume of transfers not only to ailing industries but also to individuals. As he had said earlier, one of the main difficulties in operating the budget policy in Norway was the size of those transfers. The aim was to persuade management and employees to bear more responsibility for maintaining and securing their places of employment. For instance, it was stressed that workers in a factory would have to accept lower wages than people who worked on an oil rig in the North Sea; in future, factory owners and trade union leaders together should not be able to go to the Ministry of Manufacturing Industry and request financial support because they wished the factory workers to have the same wages as those on the oil rigs. Mr. de Vries had in fact put his finger on the sore spot in indicating that it was essential to prevent incomes in the oil and gas industry from affecting other sectors too strongly. A further point on which great insistence was placed was that wage earners in the public sector and other earners in a sheltered sector should not be allowed to become income leaders. The discussion on those points, which was very intense in Norway at the present time, was helpful as it placed considerable pressure on some of those who were trying to obtain what might be considered an undue proportion of the national income.

While the economic problems of Norway did not differ very much from those of other industrial countries, Mr. Vidvei observed, the revenue from oil had given the country some additional room for maneuver, and the people were traditionally willing to solve conflicts of interest without endangering the proper functioning of society. However, a general question worth considering was why it seemed to be becoming increasingly difficult both to maintain full employment and to contain inflationary tendencies. The explanation might well lie outside the sphere of economics.

Commenting on the relations between Norway and the Fund, Mr. Vidvei noted that the Norwegian authorities considered that the Fund had a role of crucial importance in world economic affairs. With its extensive foreign trade, Norway was very dependent on the orderly operation of the international monetary and payments system, and on efforts to keep the world economy healthy. The Fund had for many years served Norwegian interests well, and the country would hardly have reached the highest level of income per capita that it enjoyed without the efforts made by and through the Fund to foster worldwide economic cooperation. However, there were in Norway serious concerns about the possibility of achieving greater stability in the international monetary system. In the words of the Governor of the Norges Bank, much could still be desired in that respect. The enormous problems besetting the world economy at present called for some of the pioneering spirit that characterized international economic cooperation in the first decade after World War II.

The Acting Chairman made the following summing up in concluding the discussion:

Executive Directors commended Norway for combining external balance with low unemployement in 1980-81 despite sluggish traditional exports. They noted, however, that this favorable development coincided with the leveling off of economic growth in 1981 and a resurgence of price and wage pressure. Directors felt that the rising inflationary pressure was adverse to solving Norway's main economic problem that has arisen with the development of the oil and gas sector. This problem has been to keep the traditional exposed sector competitive, so as to maintain full employment with an acceptable regional balance.

Directors thought that past attempts to solve this problem through employment support at existing places of work have reduced labor mobility, and slowed the adjustment of the non-oil economy to changes in the structure of demand, thereby aggravating the task of restoring competitiveness. They also noted that employment support, together with improvements in social benefits and lower income taxes, had led to highly expansionary fiscal policies, adding considerably to the inflationary pressures and leading to a tighter stance of monetary policy than would otherwise have been necessary.

Directors, therefore, supported the new Government's objectives of tightening fiscal policy, moderating wage increases, and stimulating productivity growth, in order to strengthen the position of the traditional inndustries. They believed that these aims would be in line with the Government's desire to prevent too heavy a dependence on the oil sector and to minimize the conflict between improving competitiveness and preserving regional balance.

Several Directors agreed that, given the overall balance of payments position, the use of exchange rate policy to maintain the competitiveness of the traditional exposed sector would not be appropriate, even though some loss of cost competitiveness in 1982 may be unavoidable. Another view expressed was that exchange rate policy should be geared solely to the traditional sectors.

Directors considered that a tightening of fiscal policy would be needed to contain income expectations and wage drift, and that it would facilitate the task of limiting the supply of liquidity to the public. In this context, several Directors thought that the time horizon of planned tax reductions, as well as of reductions in transfer payments, may need to be reviewed. To achieve the task of limiting the supply of liquidity to the public, Directors felt that a more flexible interest rate policy and a strengthening of the instruments of monetary policy would be required. It would be helpful if the central bank were able to conduct open market operations in its efforts to contain money supply. Such a policy, again, would require a rise in interest rates, which are at present low in real terms.

Directors noted that the external current balance is expected to shift into deficit in the medium term, given the substantial scaling down of previously expected oil revenue, partly due to lower oil prices. However, they felt that these deficits could be financed.

Norway was commended for being guided by a strict policy of energy conservation notwithstanding its large output of oil, gas, and hydroelectric power.

Finally, Directors commended Norway's exemplary record in the field of development assistance.

2. COMPENSATORY FINANCING FACILITY - MEANING OF "SHORTFALL LARGELY ATTRIBUTABLE TO CIRCUMSTANCES BEYOND THE CONTROL OF THE MEMBER"

The Executive Directors took up a paper dealing with the meaning of "shortfall largely attributable to circumstances beyond the control of the member" in connection with the compensatory financing facility (EBS/82/42, 3/12/82).

Mr. Erb recalled that when the Executive Directors had been discussing the paper entitled Compensatory Financing Facility - Experience with Requirement of Cooperation (EBS/81/251) at EBM/82/39 and EBM/82/40, some Directors had been uneasy because of the feeling that at least some of the interpretation and recommendations of the staff reflected an attempt to impose upper credit tranche conditionality on the compensatory financing facility. In the same way, he had an uneasy feeling that some of the interpretations of what lay beyond the control of the member were so broad that in effect drawings under the compensatory financing facility could be made when a stand-by arrangement would be appropriate, the difference being that drawings under the compensatory financing facility were not subject to the conditionality, phasing, or reviews normally associated with stand-by arrangements. He would certainly agree with the staff that the decision on the compensatory financing facility left open the possibility that the compensable amount of the shortfall might be reduced on account of decisions that had the effect of creating a shortfall or increasing its size. A deliberate accumulation of stocks was just one example of a circumstance in which an adjustment might be appropriate.

There might be other types of government policies that would also justify an adjustment because the policies had the effect of creating a shortfall or increasing its size.

Commenting on the substance of EBS/82/42, Mr. Erb said that he understood the introduction to Section 2, Effects of Policy, on page 4 to mean that if a country had been pursuing inappropriate economic policies that had adversely affected exports, if the country changed its policy in the shortfall year, and if the new policy was expected to lead to an increase in exports, the country would be eligible for a drawing under the compensatory financing facility. He did not follow the staff's argument in favor of such a view. While the switch from inadequate to adequate policies might be desirable, it did not negate the requirement that the export shortfall should be largely beyond the control of the member. Since the shortfall would reflect the results of government policies, both past and present, a drawing under the compensatory financing facility seemed inappropriate; a stand-by arrangement would be much better. The same could be said for proposals to promote economic growth, conservation, and export diversification, discussed on page 5 of the paper. While such policies were welcome, they were not beyond the control of the government. Consequently, a stand-by program would again be more appropriate as a means of bringing about financial adjustment.

So far as commodity stabilization policies were concerned, Mr. Erb stated that the staff should continue to subject each stabilization arrangement to a careful analysis; it should not automatically treat a volume shortfall resulting from the operation of export quotas as being outside the control of the member. Adjustments in the shortfall should be made when appropriate, and it might turn out that an export quota arrangement did in fact exacerbate the shortfall. It was important not only to look at the impact of the export quota system in the shortfall year, but also on the performance in the preceding and following years. More fundamentally, export quota arrangements should more properly be handled through the buffer stock facility rather than the compensatory financing facility. Arguments that export quota agreements ultimately reduced disbursements under the compensatory financing facility over time were irrelevant when making judgments under the compensatory financing facility.

Taking up Section 4c, Shortfalls for major exporting countries, on page 11 of EBS/82/42, Mr. Erb said that he agreed with the staff in thinking that a shortfall due to a fall in unit prices could be regarded as beyond the control of the member. However, the staff did not explicitly say that it was necessary to examine carefully a volume shortfall when incurred by price-takers. Such an examination was necessary not only for dominant market producers, as mentioned by the staff, but also for price-takers. For instance, if a price-taker set its price above market levels, the volume shortfall was likely to be larger than it would otherwise have been. Insofar as dominant exporting countries were concerned, he wondered how the staff judged whether a country's attempt to maximize export revenues was appropriate. Over what period of time did it evaluate a country's efforts to maximize earnings? In a recent case the staff seemed to have focused on the member's behavior only in the shortfall year and not in the preceding years.

He could in principle accept the staff proposal that an adjustment on account of an increase in stocks in the shortfall year should not be made if the increase restored the stocks to normal levels. However, it would be difficult to judge what might be meant by "normal." It would also be interesting to know in what sort of case the staff would have made adjustments if it had been following its own proposals in the past. For instance, a country might decide to reduce its excess production instead of increasing stocks. Thus, adjustments to a shortfall might be necessary if a larger than justified cut in production was implemented. While such adjustments would be difficult, they could certainly be made if the staff tackled the matter in a reasonable way.

Mr. Narasimham stated that his chair could broadly go along with the suggestion by the staff that existing procedures should continue to be followed in a flexible manner, but with the modification that the staff had indicated for the treatment of stocks. He was glad that the staff had drawn the useful distinction between the effects of policies on the trend of exports and the effects of policies on exports in the shortfall year. The nature of the compensatory financing facility was such that its major concern should be with temporary and reversible factors. The general point, in the present state of the world economy, was that the shortfall in export earnings for developing countries very often stemmed mainly from exogenous factors. As had become quite manifest, the policies of industrial countries and, even more, the workings of the external economic environment, had contributed to the difficulties faced by the developing countries in the form of lower exports and lower prices. The compensatory financing facility was but small compensation for the erosion of the purchasing power of developing countries stemming from the functioning of the world economic system, so that a liberal test was called for in interpreting factors that were deemed to be beyond the control of a member. The Fund should avoid giving the impression that it wished to undertake such a detailed scrutiny of the factors involved that it would lead to unjustified interference with the domestic policies of member countries. Such factors as inadequate producer incentives could not be reformed overnight, even if the authorities were moving in the right direction. While he appreciated the need for appropriate policies to stimulate investment and production, it was important not to lose sight of the time required for implementing such policies.

He did not favor the inclusion of overvaluation of currency as one of the factors in determining the nature of the shortfall, Mr. Narasimham stated. One reason was that it was difficult in most cases objectively to determine whether a currency was overvalued or not and, if so, to what extent. Measuring the equilibrium rate of exchange was extremely difficult, as Mr. Legarda had mentioned recently. Moreover, experience showed that in at least some non-oil developing countries, despite substantial changes in exchange rates, imbalances in the merchandise account did not correct themselves as desired. Furthermore, the rapid exchange rate fluctuations in the industrial countries had rendered difficult a balance of payments adjustment process in the non-oil developing countries. The recent seminar held by Executive Directors had indicated, if anything, that no definite conclusion could be reached on the advantages of devaluation and that, in any event, exchange rate policy had wide ramifications for various sectors of the economy. At EBM/82/39 and EBM/82/40 he had referred to the need for preserving the distinctive character of the compensatory financing facility and for recognizing the special factors that brought a member to request a drawing under the facility. A liberal interpretation of the circumstances in which a member might have access to the compensatory financing facility should therefore be continued; the Fund should resist the temptation to circumscribe the use of the facility and require members to turn to its other resources.

Mr. Laske commented that he was doubtful whether the practice followed by the staff hitherto in applying the concept of "beyond the control of the member" had always been in conformity with the notion of the temporary use of the Fund's resources or their revolving character. He had been impressed by what Mr. Erb had said on the circumstances in which shortfalls should be financed by stand-by arrangements with the Fund, because in a number of cases shortfalls had probably been the result of policies pursued by the authorities rather than by the outcome of factors over which the authorities could have no control.

He had been struck by the number of examples that had been given in the paper of circumstances that could be considered to be beyond the control of the member, Mr. Laske stated. In particular, he had been rather surprised by the staff approach in Section 2a, dealing with policies to promote economic growth, conservation, and export diversification. There the staff had said that a future increase in the volume of exports, to be expected from the coming on stream of new investments, was incorporated into the calculation of exports in future years. He would not expect such prospective exports, deriving from capacity that was not yet on stream, to be taken into account. He was even more surprised to read that the staff considered that the failure of such new investments would be considered as a factor that was beyond the control of the member. He would be grateful for an explanation of why those specific factors had entered into the calculations thus far.

He had also been rather surprised by the staff's attitude toward commodity stabilization policies, Mr. Laske continued. A distinction ought to be made between countries that were party to commodity agreements, according to whether they were large or small suppliers of the commodity concerned. For small suppliers of the commodity an export quota could well represent a limitation on exports, and that limitation could reasonably be counted as beyond the control of the member. But he seriously doubted whether such a benefit of the doubt could be granted, without more analysis, to members of commodity arrangements that were large suppliers or even dominant suppliers of the commodity in question. For those countries, each request would have to be considered on its merits.

Whether it was reasonable to consider the rebuilding of stocks to normal levels as outside the control of the member would depend crucially on what should be deemed "normal," Mr. Laske observed. He would be grateful if the staff would explain how it intended to deal with that matter. In his view, a case-by-case approach was the only justifiable one. For instance, he doubted whether a rebuilding of stocks to normal levels should be taken into account if the demand for the particular commodity was such as to make for stable or even rising prices. He could of course agree that in the reverse case--meaning that without any rebuilding of stocks prices would deteriorate--it would be legitimate to make a correction in the calculation of the shortfall to allow for the rebuilding of stocks. However, as a general principle, allowance for a rebuilding of stocks to normal levels should only be permitted after close examination of the circumstances.

Mr. Lovato commended the staff for the clear presentation of a number of important issues. He broadly agreed with the conclusions in EBS/82/42. He would make two points. First, the staff had correctly reminded Executive Directors that to obtain access to the compensatory financing facility, a member had only to prove that the shortfall for which compensation was sought was largely beyond the control of the member. Furthermore, the portion that was considered to be within the control of the authorities need not be subtracted, even though it might be when it was considered to be the result of a voluntary act. The point was worth making, especially as from time to time Executive Directors had challenged proposals for drawings under the compensatory financing facility on the grounds that some portion of the shortfall, deemed "dubious," had not been subtracted.

Second, on the question of what sort of pricing policies should be considered within the control of the authorities, Mr. Lovato remarked that some further clarification might be in order. The staff appeared to be arguing that, while the Fund recognized the right of countries to use pricing policy as a tool to maximize income from the sale of products, if that policy resulted in a fall of exports or in an unwanted accumulation of stocks, the effects of the policy should be considered to be within the control of the authorities. Such an argument seemed to imply that the Fund, while considering a pricing policy appropriate, would in effect "punish" members for whom the policy had not had the desired result.

The same sort of difficulty appeared to apply to the argument regarding the exclusion of stocks, Mr. Lovato continued. There were many cases in which the arguments used by the staff to justify the inclusion of stocks for countries that were members of a cartel and had been allocated export quotas might also apply to other countries for which stockbuilding was excluded. Indeed, if a particular commodity was produced by only a few countries, it was quite conceivable that those countries should agree to set prices in such a way that they would have to build up stocks. Cobalt seemed to be only one such example. While countries acting together in that way did not have formal export quotas, their oligopolistic behavior could be considered to be similar to that of countries with export quotas.

In any event, there was surely no real reason for treating differently countries that were members of cartels and countries that wished to build up their stocks. Such questions were quite fundamental; they deserved more thorough treatment in the future, and further thinking on the topic would be desirable.

Mr. Kafka stated that he was in complete agreement with the staff, including the proposal on page 12 of EBS/82/42 regarding the rebuilding of stocks. The staff had presented a comforting analysis in showing that in 85 per cent of the cases the Fund had been dealing with price problems and that in another 8 per cent or 9 per cent it had been dealing with political problems. The conclusion seemed to be that the number of cases in which it might be justifiable even to consider to refuse the request was very small indeed.

Speakers had raised a number of interesting conceptual points, Mr. Kafka considered. The most interesting was that made by Mr. Erb, namely, what the Fund's attitude should be to a country that had changed its policies to promote exports, only to find that it obtained a larger shortfall as a result. His response to the question of the proper treatment of such a country differed from that of Mr. Erb. If, for instance, the country had followed the correct policy on exports from the outset and had then encountered a shortfall, there would be no question that it was entitled to draw on the compensatory financing facility. It would surely be paradoxical for the Fund to take the attitude that if a country moved from an inappropriate policy leading to small exports to an appropriate policy leading to large exports, the Fund should therefore deny it access to the compensatory financing facility. Mr. Erb could legitimately claim that if the country's previous policies had brought about lower exports than should normally have occurred in the shortfall year, the Fund would adjust the shortfalls to take account of those policies. But it would surely be quite wrong to adjust the shortfall downward because the country had finally adopted appropriate policies.

He agreed with Mr. Lovato regarding adjustments for quotas under international agreements, Mr. Kafka continued. Regarding the question of large price-makers versus small price-takers, he was certain that the staff took the difference into account. In any event, he did not believe that small price-takers should be punished for behaving in accordance with the dictates of an international agreement. As to including prospective exports expected to occur as the result of investment, he was sure that the staff examined where the new investments actually took place, in order to decide whether they were likely to lead to additional exports. Such a procedure seemed entirely appropriate; if the compensatory financing was to be centered on a shortfall year, the Fund would have no option but to be sufficiently courageous to make estimates of future exports.

Mr. Williams said that it was clear that the criterion "shortfall attributable to circumstances beyond the control of the member" would sometimes involve the staff and the Executive Board in difficult judgments in connection with the compensatory financing facility. He would endorse the staff recommendation that the procedures used in the past should continue to be applied, and that the factors traditionally regarded as beyond the control of the member should for the most part remain unaltered.

He would, however, make specific comments, which were similar to those by Mr. Laske and Mr. Erb, Mr. Williams went on. He hoped that the staff would continue to give due consideration to any readily identifiable domestic factors underlying volume shortfalls in exports. It would be useful on occasion to have fuller assessments of the effects on exports of, for example, a deficient infrastructure or the persistent maintenance of an unrealistic exchange rate. It was not true that exogenous factors were dominant when sharp movements in export receipts occurred. For example, there were political factors. Difficult questions might arise in cases where political disturbances were experienced, but each case involving political disturbances should be examined on its own merits, and the staff should take into account the extent to which the authorities had taken prompt and effective steps to rectify the damage to the economy.

On the question of regarding the product of new investment coming on stream in the postshortfall years as being beyond the control of the member, Mr. Williams observed that it would be unnecessary to exclude the effects from the calculations of the total export shortfall if the impact were only minor. However, it was not clear that the same attitude should be taken when the impact on exports was either substantial or sudden. After all, the decision to bring a new facility on stream must often be within the control of the authorities; and if the decision were taken in the immediate postshortfall period, it could result in an artificially exaggerated calculation of the export shortfall. It would therefore be useful if the staff would comment on the possibility of quantifying and excluding that type of effect.

Similarly, Mr. Williams considered, it was questionable whether volume shortfalls resulting from the operation of quotas under commodity arrangements should necessarily be regarded as being outside the control of the member. The objective of such arrangements was said to be to help stabilize export earnings over a number of years, thereby, inter alia, reducing requests for drawings on the compensatory financing facility. While that might be the outcome in most cases, there was no guarantee that it would be in all. In considering future requests for drawings under the compensatory financing facility, when it was thought that export quotas had contributed to a shortfall, the staff should make some assessment of the operation of the particular commodity agreement and of the extent to which the individual country was a price-taker or a price-maker within the agreement. On the other hand, he could accept the staff's suggested modification to the treatment of stock accumulation when it was designed to return stocks to a normal level. However, it would be helpful if the staff would in appropriate cases express its view on the appropriateness of the normal level. Could the staff also give its views about the treatment of the situation in which a government deliberately held down production as an alternative to accumulating stocks. The effects on the calculated shortfall would presumably be the same and arguably should be treated in the same way, although he could see that there might be difficulties in trying to quantify the difference between actual and potential production levels. The staff had not said how it would handle the case when stockpiling was carried out by private operators or multinational enterprises rather than by governments, and he would be grateful if it would do so.

Mr. Prowse said that he could agree both with the staff's analysis and with its recommendations, subject to two comments. In general, the staff seemed to have exercised sound judgment on complex and difficult issues throughout the operation of the compensatory financing facility. In particular, it had shown common sense in dealing with the problem of price-takers and price-setters. Nevertheless, it ought not to be assumed that a dominant producer that was building up stocks should necessarily be judged to have been creating an artificial export shortfall. Dominant producers were sometimes confronted by dominant purchasers, a situation that had been before the Executive Board quite recently. Sometimes the dominant purchaser was the price-setter rather than the dominant producer.

So far as the attitude to inappropriate policies, such as an overvalued currency or inadequate producer incentives, was concerned, Mr. Prowse observed that he was completely in agreement with what Mr. Narasimham had said. In connection with his remarks it was worth noting that Annex IV on page 26 of EBS/82/42 showed that inadequate producer prices, among several other factors, had only contributed to 1.7 per cent of the total shortfalls amounting to SDR 7.5 billion. The figure suggested that inadequate producer prices were not likely to have been a major issue, or likely to become one. Another interesting judgment shown in Annex IV was that low external demand had accounted for only 10.2 per cent of the shortfalls. It would be interesting to know how the staff had distinguished low external demand from international prices or unit values. His own feeling was that low external demand would often have been a major factor in creating an export shortfall.

Mr. Peroz said that he had no difficulty in endorsing the staff recommendations, and that he fully shared the comments by Mr. Narasimham, Mr. Kafka, and Mr. Prowse. In particular, he could agree with the way in which the staff had treated the special situations listed on pages 9 through 12, and with the amendments proposed for the procedures for treating stock accumulations.

In Section 3, historical experience, the staff had said that an examination of the results by individual years revealed that prices played a more important role than volumes only in the period immediately following the 1975 recession, Mr. Peroz noted. He wondered whether the staff was implying that prices had become more volatile after 1975. More generally, he wondered whether since 1977 shortfalls had been determined more by prices than by volumes.

Mr. Casey said that he was in general agreement with the staff. The whole field was one in which great care was needed, especially as the main difficulties in determining whether or not a shortfall was beyond the control of the member arose in cases where volume factors were important, as they seemed to be in the majority of requests for drawings under the compensatory financing facility.

There seemed to be two types of situation, Mr. Casey considered, in which domestic policy had been weak in the past. The first was one in which a country changed to a more appropriate policy. It would of course benefit from the improvement because export receipts would increase in the postshortfall years. If the improvement in exports was caused by a Fund program, he could see that there might be a question of double compensation. However, it would surely be quite unthinkable to create incentives for countries not to improve their policies, a point made by Mr. Kafka. The second case was one in which a country had had poor policies in the past, and continued to apply them. He agreed with the staff that such cases should be dealt with by applying the test of cooperation and offering other Fund programs.

There did seem to be some confusion regarding the question of stockbuilding, Mr. Casey observed. The staff had stated on page 12 of EBS/82/42 that it saw no objection to a country trying to maximize export earnings by cornering the market. Yet, further down on the same page, the staff had said that it did take into account shortfalls created by deliberate stockpiling of a commodity in anticipation of its later sale at higher prices. He wondered how those two statements could be reconciled. In any event, like Mr. Erb, he felt that the staff should carefully analyze the stockbuilding behavior of price-takers also, even though to do so would be a difficult task.

He agreed that adjustments should not be made in the export shortfall if a country did no more than restore stocks to normal levels, even though it would be difficult to determine whether stocks were less than normal at the beginning of the shortfall year, Mr. Casey said. Even if they were, that could be because of abnormally high sales in the previous year. There did seem to be room for manipulating stocks and the choice of the shortfall year; the staff should therefore carefully examine individual cases. He also agreed with the proposed stock adjustment for excesses in cereal import costs, with the same caveat. There was one further aspect of stockbuilding that might require attention; sometime previously a country had built up stocks of a raw material, but instead of waiting for the price to rise, it had processed the stocks, thus increasing the value added. He presumed that the Fund would not reduce the size of the shortfall because of that type of improvement in economic activity.

Finally, examining the implications for the cereal option, Mr. Casey noted that the staff had said that under the integrated scheme an excess in cereal imports could be more than offset by an excess in respect of merchandise exports. While that would be correct on many occasions, the statement did assume that new crops would be exported rather than domestically consumed. Moreover, a shift in production from one crop to another would clearly take some time. The staff should therefore consider such cases rather carefully.

The Executive Directors agreed to continue 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/82/40 (4/2/82) and EBM/82/41 (4/5/82).

3. KOREA - TECHNICAL ASSISTANCE

In response to a request from the Bank of Korea for technical assistance, the Executive Board approves the proposal set forth in EBD/82/76 (3/30/82).

Adopted April 2, 1982

4. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/82/109 (4/1/82) is approved.

APPROVED: September 27, 1982

LEO VAN HOUTVEN
Secretary