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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 81/143

10:00 a.m., November 18, 1981

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

Executive Directors	Alternate Executive Directors
	O. Kabbaj
	C. Taylor
	S. E. Conrado, Temporary
J. de Groote	
R. D. Erb	
M. Finaish	T. Alhaimus
	A. Nagashima
	R. T. Salazar
R. K. Joyce	D. I. S. Shaw, Temporary
	J. R. Gabriel-Peña
B. Kharmawan	V. Supinit
	F. Sangare
G. Laske	G. Winkelmann
G. Lovato	C. P. Caranicas
	A. Le Lorier
	A. Alfidja
	D. L. Kannangara
Y. A. Nimatallah	S. El-Khouri
J. J. Polak	T. de Vries
A. R. G. Prowse	B. Legarda
J. Sigurdsson	L. Vidvei
	Wang E., Temporary

L. Van Houtven, Secretary
M. P. Blackwell, Assistant

Also Present

African Department: J. B. Zulu, Director; O. B. Makalou, Deputy Director; A. Basu, E. L. Bornemann, F. d'A. Collings, M. Edo, C. Enweze, S. P. O. Itam, J. F. Laker, W. J. Shields. Asian Department: P. Chabrier. European Department: A. Arimo, E. O. C. Brehmer, W. E. Lewis, J. Odling-Smee, J. Perejoan-Mustaros, H. O. Schmitt, A. Sommariva. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; S. Mookerjee, Deputy Director; H. W. Gerhard, S. Kanesa-Thasan, J. M. T. Paljarvi, P. Sukachevin. Fiscal Affairs Department: C. A. Sisson. IMF Institute: D. S. Diangamo, S. Hellman, Participants. Legal Department: Ph. Lachman, S. A. Silard. Research Department: G. I. Brown. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: E. A. Ajayi, K. V. Jännäri, G. Jauregui, P. D. Peroz, F. Yeo T. Y. Assistants to Executive Directors: H. Alaoui-Abdallaoui, M. J. Callaghan, L. E. J. Coene, M. K. Diallo, F. G. Guena, A. Halevi, J. M. Jones, P. Kohnert, S.-W. Kwon, J. E. Leimone, J. S. Mair, V. K. S. Nair, Y. Okubo, J. G. Pedersen, J. Reddy, J. Schuijer, H. Suzuki, O. Üçer, J. F. Williams, Wu Y. S., A. A. Yousef.

1. ZAMBIA - 1981 ARTICLE IV CONSULTATION; AND WAIVER AND MODIFICATION OF PERFORMANCE CRITERION UNDER EXTENDED ARRANGEMENT

The Executive Directors considered the staff report for the 1981 Article IV consultation with Zambia (SM/81/196, 10/22/81) together with a proposed decision concluding the 1981 Article XIV consultation. In addition they took up a request from Zambia for a waiver and modification of a performance criterion under its extended arrangement (EBS/81/220, 11/6/81). They also had before them a staff report on recent economic developments in Zambia (SM/81/208, 11/4/81).

Mr. Sangare made the following statement:

I should like to thank the staff for presenting a set of clear and concise papers which serve as the background for our discussion today. The economic and financial difficulties facing Zambia are well known to Executive Directors. In fact, it was only about six months ago that the Board approved a request by the Zambian authorities for an extended arrangement in support of a three-year economic and financial program.

It is clear from the information provided in the staff papers that Zambia continues to suffer from a low level of economic activity and severe balance of payments problems which explain the substantial accumulation of external payments arrears. The external payments problems have their roots in the depressed conditions of the world market for copper and cobalt, which are the major sources of Zambia's foreign exchange earnings and were aggravated by the country's narrow productive base which limited economic activity outside the mining sector.

As Executive Directors will recall, the Zambian authorities' medium-term program referred to above aims at stimulating growth by diversifying the structure of production, creating domestic financial stability, and improving the balance of payments position. To achieve these objectives, the authorities have taken corrective action in key sectors of the economy. In the agricultural sector increases in producer prices ranging from 19 per cent for maize and dairy products to 51 per per cent for rice have been put into effect. The National Agricultural Marketing Board is being reorganized to, among other things, ensure timely payments to farmers and reduce its own operating cost. As a result of good weather and the measures taken to stimulate agriculture, production has increased substantially in 1981. The maize crop, the staple food of Zambia, is estimated to have doubled to nearly 1 million tons, about 300,000 tons more than the national requirement. Significant production increases are also expected for wheat, rice, groundnuts, soya beans, tobacco, and sunflower seeds.

In the mining sector, the issues which led to industrial action and the attendant disruption of copper production during the first half of the year have been resolved. The authorities have decided to merge two of the mining companies and to encourage early retirement of personnel with a view to saving cost. Furthermore, to boost copper exports priority was accorded to payment of outstanding port charges to Tanzania, and increasing use is being made of the southern route through Zimbabwe. Despite the small contribution that the mining sector is expected to make to total value added, GDP is projected to grow by 5 per cent in 1981, which is the highest rate recorded in a number of years.

In the fiscal area, the authorities are pressing on with the objective of improving the financial position of the Government. Confronted with loss of revenue from mining companies in 1981, the authorities took steps to strengthen the revenue base by increasing excise taxes on various commodities and improving income tax collection. Cigarette taxes were raised from K 0.02 to K 0.05 a pack, depending on quality, and petroleum taxes from K 0.008 to K 0.003 a liter. In addition, several taxes formerly suspended due to liquidity problems in certain companies have been reimposed, including the increase of K 0.02 in duty on each bottle of clear beer and the K 0.06/kg levy on sugar. Other revenue measures include domestic sales tax increases ranging between 2 1/2 and 5 percentage points, an increase in sales tax on imports from 10 to 12 1/2 per cent, and reinstatement of the company income tax at 50 per cent. Thus far, tax collections have exceeded original estimates, and 1981 revenues are projected to total K 900 million compared with K 858 million envisaged under the program.

The authorities are giving particular attention to the need to restrain government expenditure. A major step in this regard is the decision to reduce subsidies by 41 per cent and other constitutional and statutory obligations by about 49 per cent. The decrease in subsidies is due in large measure to the elimination of expensive maize imports because of the good harvest in 1981, as well as to the adoption of appropriate pricing policies for goods and services provided by the public sector. Total recurrent expenditures, however, are expected to be about 8 per cent higher in 1981 than originally estimated primarily because of wage increases granted in the second half of 1980 and because of the Government's assumption of some local government salary obligations. To limit further wage expenditures, the Government has decided to restrict personnel recruitment to technical positions only. Reflecting these measures, the overall budgetary deficit as a percentage of GDP in 1981 is expected to decline sharply to 7 per cent from 16.0 per cent in 1980.

With regard to monetary policy, efforts to contain domestic demand are also reflected in recent data. Total domestic credit of the banking system and the system's net claim on government were within the ceilings targeted for the end of September 1981. This

reflected large revenue collections and the determined efforts of the Government to contain expenditure authorization. By limiting government recourse to the banking system, the authorities hope that sufficient credit will be made available to the private sector and those public enterprises that are engaged in productive investment. Consequently, the staff expects the monetary targets for 1981 to be met. In March 1981, the rediscount rate was raised from 6.5 per cent to 7.5 per cent. The preferential lending rates for agriculture and manufacturing were eliminated with the maximum lending rate to all sectors now at 12 per cent.

In the external sector, a particularly worrisome problem for Zambian authorities is the continued weakness in the country's balance of payments position, reflecting lower export earnings resulting from falling world prices for copper and higher than anticipated service payments abroad. In fact, the authorities had had to reduce the volume of imports by as much as 18 per cent as a result of lower export earnings, the adverse implications of which cannot be overemphasized. As indicated in EBS/81/220, both the current account and the overall deficit will exceed the program targets by about SDR 100 million in 1981. On exchange rate policy, although the authorities believe that the present exchange rate for the kwacha is adequate they have, nonetheless, stated that they are monitoring developments very closely and would not hesitate to take action should the need arise.

In the present circumstances where gross international reserves are at a level sufficient to cover only 2.2 weeks' imports, Zambia finds it difficult to reduce external payments arrears as originally planned for 1981. By the end of September, external payments arrears had increased to SDR 574 million, compared with the adjusted ceiling of SDR 447 million. The authorities believe, and it is true, that the excess over the ceiling would have been only SDR 77 million if the ceiling were adjusted to take account of the fact that the starting point reached prior to the adoption of the program was underestimated by about SDR 100 million. The failure of Zambia to meet the September criterion on external payments arrears was also due in part to the delay in the second purchase under the extended arrangement. The authorities therefore request a waiver of the performance criterion on external payments arrears for the end of September. They are also seeking the approval of the Board for an upward adjustment of the end of December 1981 ceiling for arrears to SDR 399 million to take account of the underestimation of the base figures.

In view of the fact that the authorities have been able to meet all the performance criteria, except that on arrears, and of the staff's assessment that the fiscal and monetary objectives of the program for 1981 can be attained, I hope that Executive Directors will adopt the proposed decision contained in EBS/81/220. As indicated in the letter from the Minister of Finance and the Governor of the Bank of Zambia, attached to EBS/81/220, the Government of Zambia is

fully committed to the medium-term program and is prepared to take additional measures where necessary to ensure the realization of its goal.

Mr. Nimatallah remarked that Zambia was in the first year of a three-year extended arrangement with the Fund. There had been encouraging developments in the agricultural sector over the past year with increasing production due in part to the various incentives incorporated in the extended arrangement program. He hoped that those incentives would be continued. Performance in the mining sector had not been encouraging over the past year, partly because of labor problems and partly because of persistent financial difficulties in the mining companies. It was most important that the authorities should take action in that sector along the lines envisaged in the extended arrangement program.

On the fiscal side, Mr. Nimatallah continued, performance during 1981 had been much better than during the previous year. Nevertheless, some difficulties had been encountered in meeting the ceiling on expansion in net domestic credit to the Government for the end of June 1981. The ceiling for the end of September had been met after a sharp reversal from the end of August when net domestic credit to the Government had reached very high proportions. Those developments emphasized the need for the authorities to monitor government expenditures closely in order to ensure that the December ceiling would be met. On the monetary side, credit expansion had slowed somewhat during the first half of 1981 following lower credit requirements by the Government. However, credit to the private sector seemed to have increased rather sharply. Could the staff say whether the ceiling established by the central bank on the lending activities of commercial banks had been generally effective?

He agreed with the staff that exchange rate policy should be kept under constant review, Mr. Nimatallah observed. Perhaps the staff could comment on the Zambian authorities' view that the present level of the exchange rate was adequate. With regard to external arrears, he wondered whether the prescribed reduction by SDR 175 million during the last quarter of 1981 was feasible, given Zambia's balance of payments problems. He suspected that a smaller reduction might be more realistic. He would be grateful if the staff could comment on the latest developments in the level of external arrears.

The Zambian authorities deserved commendation for the corrective policies they had implemented during 1981, Mr. Nimatallah concluded. It was obvious, however, that more needed to be done in the period ahead. He could support Zambia's request for a waiver and modification of a performance criterion under the extended arrangement.

Mr. Erb said that he could support Zambia's request for a waiver and modification of the performance criterion on external arrears, because the country's failure to meet its target stemmed primarily from the substantial underestimate of arrears at the initiation of the program.

He would appreciate some explanation of the reasons for that large underestimate, and also of Zambia's failure to meet performance criteria in June, since a subsequent rise in external arrears was attributed to the country's inability to make a drawing on the Fund following that failure. Both the high level and the pattern of arrears, which had risen steadily since the initial reduction immediately following the beginning of the extended arrangement program, gave grounds for concern. At EBM/81/76 and EBM/81/77 (5/8/81) the staff had estimated that arrears accumulation might have added as much as 25 per cent to Zambia's import costs through interest charges and markups, thereby adding considerably to the burden of adjustment. A steady reduction in arrears was a prerequisite for the re-establishment of Zambia's creditworthiness; it was necessary not only to reduce the burden of adjustment, but also to attract external capital to finance badly needed investment. In consequence, it would perhaps be useful to set monthly ceilings on arrears, which, if exceeded, would trigger consultations with the staff. Setting such ceilings would serve as a reaffirmation of Zambia's commitment to the resolution of its problems.

Zambia's performance under the extended arrangement had been rather mixed, Mr. Erb continued. Some improvement in pricing policies--particularly for agricultural goods--had led to an increase in agricultural output, a cut in budget subsidies for maize and fertilizer, and a consequent sharp reduction in maize imports. Moreover, budget revenues appeared to be growing more rapidly than anticipated as a result of better tax administration and new revenue measures. However, Zambia's balance of payments situation was expected to be worse than projected. While a part of that deterioration--virtually all in the current account--reflected lowered estimates for Zambia's exports in 1981, a substantial portion of it reflected increased payments for "other services," such as increases in port charges, air fares, and travel expenses for educational purposes. The current account situation would have been even worse had it not been for a shortfall in projected imports. Given the pressing need for new capital expenditures in the mining sector, the shortfall in imports of machinery and transport equipment gave grounds for concern. The deteriorating trend in the current account, the unfavorable prospects for a substantial improvement in external markets for Zambia's major exports over the medium term, and the continued high level of external payments arrears reinforced the staff's view that further adjustment measures were necessary if the extended arrangement program was to remain viable.

The stagnation of exports since 1979 (some of which were subsidized), the heavy reliance on trade and payments restrictions, and the real effective appreciation of the kwacha by at least 19 per cent since early 1978 argued clearly for the need for an early adjustment of the exchange rate, Mr. Erb suggested. Such an adjustment would serve to restore profitability in the dominant mining industry as well as to improve competitiveness for nontraditional exports. Further measures were also needed to control budgetary expenditures as a means of reducing the fiscal deficit and freeing resources for investment in more productive and export-oriented sectors of the economy. The staff had indicated that

expenditure overruns in the areas of wage outlays, departmental charges, and "other expenditures" had more than offset the impact on the budget deficit of a better than expected revenue performance and the assumption of external interest payments by the Bank of Zambia. While some progress had been made during the present year in reducing maize and fertilizer subsidies, the fact that subsidies still accounted for nearly 10 per cent of budget expenditures suggested that a more rapid pace of subsidy reduction through greater price flexibility could contribute importantly to better expenditure performance. In that connection, the Zambian authorities should follow through promptly on the commitment to establish a prices and incomes commission with real authority to make timely decisions on price changes and wage requests.

If the state enterprises could adopt more flexible pricing policies, they could make a better contribution to budget revenues and reduce budgetary outlays on equity purchases and loans, which diverted capital funds from other needed investments, Mr. Erb remarked. The sharp drop in savings rates since 1977, in conjunction with the increasing difficulty of obtaining external capital, should be reversed if an adequate level of investment was to be sustained. In addition to increasing public sector savings through budgetary controls, further upward adjustment of increasingly negative domestic interest rates should be made to provide adequate incentives for private sector savings.

The halting progress made so far by Zambia in resolving its external payments difficulties pointed clearly to the need for additional comprehensive adjustment measures, Mr. Erb concluded. In particular, an appropriate adjustment of the exchange rate would need to be made at an early date if a sustainable balance of payments position was to be achieved by the end of the program period. Given the severity of Zambia's balance of payments difficulties, the authorities should provide clear evidence of additional adjustment efforts before the second year of the extended arrangement program was discussed by the Executive Board.

Mr. Laske expressed broad agreement with the staff assessment of Zambia's difficult economic situation. Although the authorities had implemented most of the adjustment policies agreed to under the extended arrangement, the balance of payments situation had deteriorated further and the outlook had not improved. The failure to achieve projected export levels had led to an accumulation of external arrears beyond the limits established in the arrangement. The present level of arrears was detrimental to the country's credit standing and called for urgent remedial action.

The marked improvement in the agricultural sector was encouraging, Mr. Laske observed, since it resulted not only from favorable weather conditions, but also from the adjustments in producer prices. The abundant maize harvest, Zambia's staple commodity, should allow an expansion of agricultural exports and, if incentives were retained, to a diversification of agricultural production and exports. Could the staff comment on the country's potential for agricultural exports, and on

whether a diversification and intensification of agricultural exports could help to ease some external constraints?

The mining sector on which the bulk of the country's export receipts depended was a cause of concern, after having been adversely affected by depressed world market prices, low production levels, and transportation difficulties, Mr. Laske noted. The actions introduced by the authorities after the recent disruptive labor disputes should be carried through with determination. Plans to improve productivity by attrition in the overlarge labor force and by streamlining management should be given the highest priority.

The authorities should take urgent steps to consolidate the budgetary situation, Mr. Laske recommended. The staff had indicated that some consolidation was under way, although the nonobservance of the credit ceilings in June raised a question mark about the authorities' commitment to the adjustment policies they had agreed to implement. He recognized that the overshooting of the ceiling had been relatively minor and that the ceilings had been observed at the end of September, but he wondered whether the achievement of the September credit ceilings had not been at the expense of running up further external arrears. The continued large share of the Government in credit expansion had been made possible by imposing ceilings on bank lending to the private sector, and might make necessary some adjustments to interest rate policy. Whereas the projected rate of inflation was in the 14 per cent to 16 per cent range, interest rates--both on the lending and on the deposit and savings sides--were well below those figures. The interest rate on treasury bills had been increased to 6 per cent, a level that could hardly be considered an incentive for investors. He wondered if by raising treasury bill rates further, more nonbank sources could be mobilized to finance the budget deficit, so as to leave more room for the private sector within the overall credit ceiling.

Given Zambia's exposed situation in the world market for copper and the regrettable extended import restrictions, the nominal exchange rate might not be an immediate problem, Mr. Laske commented. However, as Mr. Erb had noted, the effective exchange rate of the kwacha had appreciated considerably over the past three years. The obvious need to adjust the external situation should, therefore, not preclude the use of exchange rate mechanisms to improve resource allocation. He supported the staff view that for both medium- and long-term considerations a review of the exchange rate was highly advisable. He welcomed Mr. Sangare's assurance that the authorities were determined to monitor closely developments in the exchange rate area. Certainly immediate attention would have to be given to external arrears, Mr. Laske said. Unless the level was reduced rapidly, Zambia's creditworthiness would be further eroded thus limiting the availability of needed inputs for the rehabilitation of the mines and the continuation of ongoing investment projects. The new arrears ceiling proposed for the end of December 1981 required a drastic reduction in arrears over the coming weeks. If the proposed decision was approved, Zambia would be able to draw on those resources

that had been blocked in September as well as on an additional tranche under the extended arrangement. Was he right in supposing that the amounts drawn from the Fund would be applied to the reduction of the outstanding arrears?

Mr. de Vries remarked that Zambia's economic performance under its extended arrangement had been mixed. A number of important adjustment measures had been taken and some deteriorating trends had been halted. However, a sustainable internal and external situation was not yet in sight. In fact, it was not easy to see how Zambia would repay the resources it had drawn from the Fund, nor how the Fund could wind down its involvement in Zambia during the foreseeable future. In the short-term perspective, he welcomed the fact that the performance criteria had mostly been met in September 1981. While the authorities deserved commendation for that success, the fact that several performance criteria had been missed during the previous quarter did not inspire confidence in the solidity of the country's economic program. Additional measures were clearly necessary if a sustainable situation was to be reached.

The authorities should consider what action was necessary with regard to their pricing policies and their exchange rate policies, Mr. de Vries recommended. They should take steps to ensure a better allocation of budgetary expenditures and should assume greater overall control of the budget. Some action should be taken to raise negative interest rates and to clear up arrears.

He found it of great concern that after the initiation of the extended arrangement arrears had continued to rise, Mr. de Vries stated. If the Fund granted a waiver to the performance criterion relating to arrears, the Zambian authorities would no doubt use the new tranche of resources made available to them by the Fund to reduce the level of arrears. Given the expense of obtaining credit through the accumulation of arrears, he would support Mr. Erb's suggestion that monthly ceilings for the level of arrears should be set, which if not achieved would necessitate consultations with the Fund.

Mr. Taylor said that he hoped that at the end of the discussion he would be able to support the proposed waiver. While acknowledging that Zambia had been hard hit recently by circumstances beyond its control he did not feel able to agree to the proposed waiver without receiving some assurance from the staff about progress in Zambia's external financial situation. The proposal for a waiver raised several rather important questions. The staff had indicated that the level of external payments arrears was some SDR 100 million higher than had been estimated at the time of the program's commencement. That seemed to indicate that the authorities' arrangements for monitoring arrears were far from adequate. Were the authorities and the staff now satisfied that the new estimates were reliable and that the centralized monitoring by the Bank of Zambia was working effectively? A more basic question was whether the adjustment originally foreseen under the extended arrangment was still adequate. In particular, could the staff say whether the original arrears target

for the end of 1983 of SDR 61 million still held good? As a matter of general principle, it seemed desirable that any increase in the level of external arrears between the negotiation of a program and its approval or its consideration by the Executive Board should be fully explained at the earliest opportunity. There might well be a need to monitor short-term debt fluctuations more comprehensively in Zambia, if medium-term indebtedness was to be an effective performance criterion.

The data on Zambia's external debt were not current and a sharp capital inflow in 1980 had gone unexplained, Mr. Taylor continued. The staff had indicated that foreign exchange requirements had not been taken into account or had been underestimated in determining foreign exchange allocations. In view of the uncertainty surrounding circumstances in the external sector, he would welcome some reassurance from the staff that the new figures presented in EBS/81/220 were reasonably comprehensive and accurate. If such a reassurance could be made he would agree to the proposed waiver and modification. The performance criteria for December 1981 had been correctly adjusted to take account of Zambia's drawings under the compensatory financing facility; could the staff confirm that the criteria would be further adjusted should the authorities, in due course, obtain augmented drawings under that facility? Could the staff also explain whether the credit ceiling for December 1981 had been set at a level sufficient to meet the enlarged financing needs that were likely to be created by the substantial expansion in agricultural production taking place during the year?

He broadly agreed with the staff's appraisal of the Zambian economy, Mr. Taylor stated. The authorities were to be congratulated on the comprehensive progress they had made on a number of fronts under the extended arrangement. Nevertheless, Zambia continued to face unfavorable medium-term prospects, particularly in the area of external trade and payments. He hoped that the need for further and sustained adjustment efforts would be reflected in the program for the second year of the arrangement, and also that the World Bank would be fully involved in formulating that program and in program reviews. The pursuit of an appropriately tight fiscal stance was obviously crucial to the adjustment process. It was essential that the authorities maintain tight discipline on expenditures in order to stay within the budgetary projections; he welcomed the measures that had been taken thus far to achieve that objective. It was to be hoped that the authorities would continue with the phased reduction in budgetary subsidies, and that further significant progress toward economic pricing would be achieved by the parastatal organizations during 1982. It was also to be hoped that future wage awards would be safely contained within the budgetary ceilings.

There was a need to monitor revenue performance closely, Mr. Taylor suggested. While recognizing that Zambia's rather heavy tax burden in relation to GDP caused problems, he believed that it might be necessary to strengthen the domestic revenue base in the second year of the program. He would be interested in the staff's comments on the possible scope for a shift toward ad valorem taxes. The general stance of monetary policy

seemed appropriate; however, the authorities should consider whether the present negative real interest rates should not be raised in order to promote domestic savings. The authorities should continue their efforts to develop the agricultural sector, because it was probably the only sector in Zambia that could be used to reduce excessive dependence on copper. In that context, it was important that producer prices be maintained at realistic levels; the timely increases for the 1981/82 season were welcome.

Clearly Zambia's balance of payments problems stemmed, to a large extent, from its great reliance on copper exports, Mr. Taylor said. Anything that could be done to lessen that dependence would be valuable. It should not be forgotten, however, that efficiency and investment in copper mines would need to be improved. The exchange rate had been relatively stable in nominal terms following the significant real appreciation between 1978 and 1980. He hoped that the exchange rate would continue to be carefully monitored, particularly in view of the need to maintain or even improve the profitability of the mining sector. Exchange rate policy would have to be dealt with comprehensively within the framework of the second-year program.

Mr. Alfidja commended the Zambian authorities for the important measures they had taken to stabilize and strengthen their country's economy. They were facing considerable difficulties and it was only reasonable that the Fund should continue its support, so as not to jeopardize what had been achieved thus far. Zambia needed significant external financial assistance if it were to succeed in diversifying its economy and in making it less dependent on the mining sector. Zambia's economic program was being implemented smoothly, despite some minor slippages. He could support the request for a waiver and modification of a performance criterion and also the proposed decision relating to Zambia's exchange measures subject to Article VIII.

Mr. Kharmawan recalled that Zambia's economy had been facing serious problems before the beginning of the extended arrangement. In meeting Zambia's request for an extended Fund facility program, the Fund had recognized that recovery would need to be spread over a number of years, and that it would be unreasonable to expect the country's balance of payments situation to become sustainable after only one year. In consequence, the Executive Board could not expect to see dramatic improvements in Zambia's balance of payments at the present review.

The authorities should be encouraged to continue with the measures they had taken to lessen dependence on the mining sector by diversifying their economy through the encouragement of agricultural production, Mr. Kharmawan said. On the whole, the authorities' performance during the first year of the extended arrangement had been satisfactory. Most of the measures planned for the first year had in fact been implemented. There had been a slippage in June when the credit ceiling had been slightly overshot; however, the courage and determination of the Zambian authorities in remedying that situation deserved commendation. The present less than

satisfactory state of the economy could not be explained by that small deviation in the June targets. In his view, the Fund ought to have been rather more lenient with regard to that slippage, since it was much more difficult to adhere to credit ceilings on a quarterly basis than on an annual basis. In Zambia's case the authorities, when faced with the slippage, had taken immediate remedial action so that the performance criterion involved had been fulfilled for the next period.

He could support Zambia's request for a waiver of the performance criterion relating to arrears, Mr. Kharmawan stated. In EBS/81/220 the staff related the failure to reduce arrears to the fact that Zambia had not drawn on Fund resources following the overshooting of the credit ceiling in June. If that were the case, the Fund might be accused of providing money to bail out creditors, which was certainly not the intention of the Fund's involvement under the extended arrangement. The Fund's resources were intended to be used to strengthen a country's economy so that it could generate its own resources to meet its needs. In Zambia the balance of payments situation remained under great pressure largely because of low export earnings; even after observing the policies agreed with the Fund, the balance of payments had not improved to the point where resources could be generated to pay back arrears. However, it was difficult to see what Zambia could do while international conditions were depressing the market for its main export product. In his view, the authorities' failure to reduce arrears stemmed from the impossibility of improving the balance of payments situation while market conditions for Zambia's export products remained so unfavorable. For that reason, Zambia's request for a waiver with regard to arrears was fully justified.

Of all performance criteria those relating to arrears were particularly important, Mr. Kharmawan continued. Reducing arrears would enhance a country's creditworthiness, since creditors would always wish to be assured that borrowed money would be paid back. If a country found difficulty in reducing arrears because of a failure of export earnings to increase during a period of weak demand, the Fund should acknowledge that the country was beset with difficulties beyond its control. Finally, it was clear that the Zambian authorities still had many steps to take in adjusting their country's economy; he would make further comments on those steps when the program for the second year of the extended arrangement was presented for the Executive Board's consideration.

The staff representative from the African Department acknowledged that in view of the deterioration of Zambia's economy and its uncertain prospects, further adjustment measures would be required. Such measures would be discussed with the authorities fairly soon when the program for the second year was negotiated. The staff shared many of the areas of concern indicated by Executive Directors and, in particular, would examine the possibility of monitoring the level of external payments arrears on a monthly basis. In that context, unlike in several African countries, Zambia's external payments arrears related only to current account transactions. Zambia had made special efforts to meet its external debt obligations on time, and as far as he knew, there were no arrears on external

debt. About 70 per cent of all external payments arrears arose from imports. The original estimates for arrears set forth in EBS/81/91 (4/20/81) had been based on information available during discussions with the Zambian authorities in February and March 1981. Unfortunately, those estimates had proved too low because, given Zambia's landlocked position and long transport routes, many of the payments that had fallen due that had not been honored in March and April 1981 were for shipments that had been ordered many months before. The increase in arrears, therefore, did not represent negligence on the authorities' part since the beginning of the program but the delayed effect of orders placed for imports six to nine months before. The figures in the staff papers before the Executive Board were more current and correct.

Setting private sector ceilings had appeared to be effective, the staff representative explained. The central bank instructed commercial banks to respect those ceilings and no problems had been noted. The objective of reducing external arrears by the equivalent of SDR 175 million by the end of 1981 seemed to be feasible given the substantial assistance that was to be provided by the Fund. The problem of monitoring external payments arrears concerned the time lag between the original and current transactions. Since May the authorities had taken a number of measures, particularly in the imports field, to assure that future import payments would remain within the bounds of available resources. The current projections for exports were rather more pessimistic than the original and would have repercussions on some of the quantified targets laid down for the end of the program period. The final outcome would depend greatly on progress during the second year of the program.

It was generally believed by both the World Bank and the Fund staff that there was substantial potential for agricultural development in Zambia the staff representative continued. In view of the present and prospective difficulties in the mining sector, developing agricultural potential seemed to represent the most realistic way of diversifying the Zambian economy. The authorities had given first priority to the achievement of self-sufficiency not only in maize, but also in wheat, rice, and various other commodities. There was no prima facie reason why production levels should not increase to the point where Zambia could export foodstuffs to neighboring countries.

The staff would examine with the authorities the possibility of a further purchase under the compensatory financing facility, the staff representative from the African Department remarked. If further purchases were to be made the staff would assess their effect on the target for arrears reduction over the coming year. He did not expect that a request for additional purchases under the compensatory financing facility would be brought before the Executive Board before the beginning of 1982. The staff believed that it was technically feasible for all the December 1981 ceilings to be met. As Mr. Taylor had mentioned, there was a possibility that if crops turned out to be larger than anticipated, there would be some need for additional agricultural credit to permit full harvesting. The Zambian President had given instructions that all the maize harvest

should be collected and farmers paid for it; it would be difficult, therefore, to refuse credit to pay for all the maize that would be stored in the fields before the end of the year. The staff would examine that question with the authorities, and would certainly maintain its stand that the credit ceiling for the Government would have to be respected as originally agreed. Incidentally, the overshooting of the June credit ceilings had been relatively minor. Even so, since it had occurred so shortly after the implementation of the program, the staff had not felt it appropriate to seek a modification of the credit ceiling at that time. Finally, the staff would consider with the authorities the possibility of introducing ad valorem taxes during the course of the second year of the program.

The staff representative from the Exchange and Trade Relations Department, recalling the suggestion regarding the establishment of monthly targets for external payments arrears, said that if those targets were exceeded there should be consultations, which he assumed would be with the staff and not with the Executive Board. Such a procedure had been adopted in a few other instances, not specifically with regard to arrears but, for example, with regard to government expenditures, where departures from monthly targets had been followed by consultations. On another point, it should be noted that the program allowed for an automatic adjustment of the level of arrears according to export performance. It was not necessary, therefore, to cite export performance as an explanation for the proposed modification.

Mr. Shaw said that he understood from the staff's replies that Zambia's arrears covered almost entirely short-term payments. Zambia was however in substantial arrears for medium-term payments with Canada and, he understood, with other creditors.

The staff representative from the African Department explained that while there were no arrears on government debts, some imports and invisibles had been reinsured by official credit agencies and might therefore have been provided through medium-term credits.

Mr. Sangare said that he had noted the call made by some Executive Directors for further control on expenditures and improvements in revenue collection. Some speakers had expressed concern about arrears and the need for Zambia to make further external adjustment; while he agreed with the comments and proposals made in that context, he would point out that the level of arrears had risen primarily because of the high interest rates that the authorities had had to pay on invisibles. Zambia's external position had also been influenced by the fact that before 1981 it had been a net food importer. Now that the country had attained self-sufficiency in that area, some pressures on the balance of payments should be relieved. Another factor affecting the country's external situation had been the deteriorating prices of cobalt and copper over the past few years. Not only had prices fallen, but the volume of production had decreased because of strikes among the labor force. Looking to the future, the settlement of the industrial disputes and the widening of the agricultural production

base and consequent diversification of the economy should enable the country to achieve its targets and make significant improvements in the external sector. Finally, he expressed thanks to Executive Directors for their comments and advice, which he felt sure would be taken into consideration by his Zambian authorities. He also thanked the staff for its work and cooperation with the Zambian authorities.

The Chairman remarked that Table 1 on page 3 of SM/81/196 demonstrated the amount of adjustment that had taken place in Zambia during 1981. It showed that the ratio of subsidies to total revenue had been greatly reduced from the levels of 1979 and 1980; that the overall budget deficit as a proportion of GDP had fallen from 16 per cent to some 7 per cent; and that, despite a 10.9 per cent deterioration in the terms of trade after a bad year in 1980, the current account deficit as a proportion of GDP had fallen from 15.8 per cent to 10.5 per cent. Indeed, as some Executive Directors had pointed out, some adjustment in prices and in the budgetary field in general had been taking place during 1981. However, despite progress made, it was clear that Zambia's projected current account deficit for 1981--equivalent to more than 10 per cent of GDP--was not sustainable. Moreover, budgetary subsidies in relation to total revenue were still very high and strong additional adjustment measures would be required if budget targets were to be kept on track. Should Executive Directors approve the proposed decision concerning the waiver and modification of a performance criterion, about 73 per cent of the Fund resources that would become available to Zambia under the extended arrangement and under the compensatory financing facility during 1981 seemed likely to be used to reduce arrears.

The Deputy Managing Director observed that the question could be asked whether it was consistent with Fund practice to use resources drawn from the Fund to reduce arrears. In his view, the answer would have to be affirmative, as long as the reduction in arrears formed part of a program that the Fund considered appropriate and likely to achieve adjustment. In approving the use of Fund resources to reduce arrears during the first year of a program, it would have to be assumed that the targets for the second and third years of the program would be met to the satisfaction of the Executive Board. Arrears were one of the most damaging kinds of exchange restriction. They were damaging not only in terms of direct cost but, perhaps even more important, in terms of indirect cost, since they made it difficult for the authorities to attract capital. In view of the pernicious nature of arrears, it appeared quite justified to use Fund resources to reduce them.

The Chairman added that he also believed it could be appropriate to use Fund resources to reduce arrears, but only if a country's economic program was designed to prevent arrears from building up again. It would certainly be wrong for the Fund to give the appearance of bailing out a country's creditors.

The staff representative from the African Department remarked that, looking at the year as a whole, Zambia's arrears would be reduced by some SDR 62 million.

The Deputy Managing Director commented that in entering into a program with the Fund a country would obviously wish to pay off its arrears as soon as possible. Using Fund resources for that purpose should not be seen as "bailing out creditors" but as helping the recipient country to adjust its economy.

Mr. Kharmawan remarked that it was difficult for a country to distinguish in its resources money coming from export earnings, from reserves, or from drawings on the Fund. Because of the difficulties in making that distinction it would be possible to argue that a country paying back arrears and drawing on the Fund was using Fund resources to clear debts. However, he did not feel it appropriate for the Fund to acknowledge that its resources could be used for that purpose. The Fund should clearly state that its resources were to be used to enable a country to improve its economy, so that it could generate its own resources and fulfill its obligations. Perhaps the subject could be dealt with in more detail during the review of conditionality that the Executive Board would be undertaking in 1982.

The Chairman made the following summing up:

> The Executive Directors were in broad agreement with the views expressed in the staff appraisal (SM/81/196, 10/22/81). They welcomed the progress achieved so far in implementing adjustment measures under the medium-term program, especially in the areas of agricultural production, pricing policies, and subsidies, but believed that much remained to be done, especially since economic and financial circumstances had proved more difficult than anticipated. Concern was expressed regarding the continued difficult balance of payments situation and in particular with the increase in arrears beyond the program targets. Directors argued that a reduction in arrears was essential to a strengthening of external confidence and to an improvement in Zambia's creditworthiness. It was suggested that arrears should in the future be monitored on a monthly basis.
>
> Directors agreed with the staff's view that the difficult balance of payments situation and the unfavorable medium-term outlook required that substantial additional adjustment measures be implemented without delay. They felt that output in the productive sectors would have to be increased through concerted supply-oriented measures--including appropriate incentives in the farm sector and the mining industry--and through a more determined policy in the area of demand management. Directors emphasized that budgetary policy was the key element of the adjustment process. While efforts to strengthen revenue collection should be sustained, further restraint on expenditure--particularly with regard to budgetary subsidies--would have to be the main means of strengthening government finances. Further flexibility in pricing and interest rates, which were clearly negative, was

called for. Given the deterioration in the financial position of the mining sector, and the authorities' aim to diversify away from the excessive dependence on mineral exports, Directors emphasized that a comprehensive review of the exchange rate policy would be desirable; several Directors considered that a depreciation in the rate was warranted.

In sum, Directors urged the Zambian authorities to implement without further delay the strong and sustained additional adjustment measures needed to achieve the stabilization objectives of the extended arrangement program. Such additional measures will be crucial for an agreement on the second-year program.

The Executive Board then took the following decision:

Decision Concluding 1981 Article XIV Consultation

1. The Fund takes this decision relating to Zambia's exchange measures subject to Article VIII, Section 2, and in concluding the 1981 Article XIV consultation with Zambia, in the light of the 1981 Article IV consultation with Zambia conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Zambia's exchange system remains highly restrictive. In the context of the medium-term program supported by an extended arrangement, the authorities intend to pursue the policies that will permit a substantial reduction in arrears and facilitate other steps toward a liberal exchange system. The Fund welcomes the steps taken by Zambia in this direction and grants approval for the restrictions on making of payments and transfers for current international transactions referred to in SM/81/196 until December 31, 1982, or the next Article IV consultation, whichever comes first.

Decision No. 6991-(81/143), adopted
November 18, 1981

The Executive Directors considered a proposed decision regarding Zambia's request for a waiver and modification of a performance criterion.

Mr. Taylor said that he had been somewhat reassured by the comments of the staff representatives and of Mr. Sangare regarding the problem of arrears. He had been particularly glad to note that a Fund mission would soon be going to Zambia to acquaint itself with developments in that area. Although he still had some reservations about the country's external situation, he could go along with other Executive Directors in supporting the proposed waiver. Incidentally, the use of a part of Zambia's drawings on the Fund to pay off arrears would provide resources to the Zambian

economy by releasing a new flow of credit that might otherwise have been held up. His hesitation in approving the proposed decision did not reflect any criticism of the way in which the Zambian authorities had been pursuing their adjustment efforts, but reflected rather the concern that the underlying balance of payments situation was worse than had been described in the staff papers.

The Executive Board then approved the following decision:

Waiver and Modification of Performance Criterion Under Extended Arrangement

1. Zambia has consulted with the Fund in accordance with paragraph 4 of the extended arrangement for Zambia (EBS/81/91, Supplement 2, May 11, 1981) in order to reach understandings regarding the circumstances in which purchases under the arrangement can be resumed, and to modify the quarterly limit on external payments arrears for end-December 1981.

2. The Fund finds that no further understandings are necessary with respect to external payments arrears for end-September 1981, and that, accordingly, purchases under the arrangement can be resumed.

3. The letter of October 29, 1981 from the Minister of Finance and the Governor of the Bank of Zambia shall be annexed to the extended arrangement for Zambia, and the Memorandum on the Economic and Financial Policies of Zambia attached to it shall read as modified by the letter of October 29, 1981. Accordingly, the quarterly limit on external payments arrears for end-December 1981 shall be SDR 399 million.

Decision No. 6992-(81/143), adopted
November 18, 1981

2. SWEDEN - 1981 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1981 Article IV consultation with Sweden (SM/81/201, 10/27/81). They also had before them a report on recent economic developments in Sweden (SM/81/211, 11/6/81).

The staff representative from the European Department explained that the reduction in value-added tax mentioned in the paper as a measure associated with the devaluation of the krona had been approved by Parliament with effect from November 16, 1981. The amount of the reduction had been somewhat smaller than anticipated, and as a result the public sector deficit for 1982 would remain the same as in 1981 rather than being reduced as the staff paper had forecast. As to the money supply, the latest information received from the Swedish authorities was that it was expected

to grow by less than 15 per cent in 1981, because of a smaller than expected central government deficit and an estimated growth in deposit money bank lending well below the target of 6 per cent. Finally, the statement regarding the currency outflow made on page 8 of SM/81/201 should refer to 1980 as a whole and not to the period May-September 1980 as indicated.

Mr. Sigurdsson made the following statement:

On behalf of my Swedish authorities and myself I extend warm appreciation of the work carried out by the Fund mission to Stockholm. The report on the economic situation in Sweden pinpoints the problems and possibilities in a through manner. We all enjoyed very much the thought-provoking deliberations with the mission.

Upon reading the report it does not take long to see that the views of the Fund--regarding the nature and extent of the problems as well as what kind of economic policy is required to cope with them--to a large extent coincide with those of the Swedish authorities.

The depreciation of September 14, 1981 constitutes an important step toward improving the competitive position of Swedish enterprises. But due to the J-curve effect, the depreciation will not have an immediate positive impact on the balance of payments current account. The improvement will occur over time, provided we are able to maintain in the years to come this improved competitiveness.

The gradual reduction of marginal tax rates, which was presented in early November, enjoys broad political support. This measure will weigh heavily as a component in future wage agreements, facilitating moderate settlements. Parallel to the suggested marginal tax cut runs a proposed reduction in tax deductions for interest payments. This will increase interest rate sensitivity in the Swedish economy, which is at the same time a precondition for a more flexible interest rate policy.

A basic feature of the Swedish adjustment policy is the orientation toward strengthening the current account through expansion of the exposed sector, manufacturing industry expansion in particular. Measures to stimulate investments and savings as well as to arrive at a more flexible labor market were therefore included in the economic policy package following the currency depreciation. Measures have also been taken to improve the functioning of the capital markets, not least the market for risk capital. Another basic element in this overall strategy is to reduce the absorption of the public sector. As underlined in the staff report, reducing the growth rate in public expenditures probably constitutes the most important task for economic policy at present.

The Government is firmly committed to its aim, presented last spring, to save SKr 12 billion in fiscal 1982/83. Part of this amount was presented in a Bill to Parliament in October 1981. The remainder of the savings program will be introduced in the Budget Bill of January 1982.

Real growth in overall public expenditures will be much slower than the rate of 5-6 per cent during the 1970s; the current rate of 4.5 per cent will come down to about 2 per cent next year. The growth rate of local authorities will also be substantially reduced, from an annual rate of 4-5 per cent in the 1970s, via the present growth rate of close to 3 per cent, to a rate of 1 per cent called for by the Government and Parliament.

The rate of inflation has been lower than expected during the autumn of 1981. According to preliminary data the consumer price index actually declined during the first half of October. One factor behind the overall more favorable price development is the lowering of the official discount rate by 1 percentage point as from October 14. Another factor is the lower than expected immediate effect of the depreciation on the price level. In view of the effect of the reduction in the discount rate and of recent price developments it was deemed advisable to reduce by half the proposed reduction in the value-added tax (VAT). This change would still avoid triggering the price clause built into the wage agreements. The rate of VAT has been lowered to 21.5 per cent from 23.46 per cent as of November 16, 1981. The combined effect on the consumer price index level of the lowering of the discount rate and the rate of VAT is calculated at about 1 per cent. Consumer prices are expected to increase by less than 10 per cent between December 1980 and December 1981. The index of the wage agreement will, however, increase less, or by close to 9 per cent, leaving a margin of some 0.5 percentage point to the trigger level. The VAT reduction now decided on, implies, furthermore, a proper level viewed in relation to developments in domestic demand.

On balance, the overall effect of the depreciation and the accompanying economic policy measures will be more restrictive than originally envisaged, implying a tighter fiscal policy stance and a somewhat lower real disposable income in 1981 and 1982. This should strengthen the trade balance but leave the growth of GDP at about 2 per cent in 1982. The restrictions on domestic demand in 1982 are intended to create scope for expansion of the exposed sector. Such expansion will, however, not be paralleled, in the first gradual upturn, by increased demand for labor. There will probably be some increase in unemployment, especially during this coming winter season. Selective labor market measures have been designed to temporarily alleviate the situation.

Mr. Lovato remarked that traditionally Sweden had provided a model of economic growth, stability, and welfare; it was now providing an example of what happened when a well-intentioned social security and unemployment system and a redistributive fiscal system were carried too far. Unfortunately, the signs of improvement in some economic variables over the past year, although encouraging, were primarily a reflection of cyclical factors rather than of structural adjustment. The devaluation of September 1981 would bring some relief but probably only for a short period of time. The authorities would have to take other measures and in cooperation with the trade unions should follow a path more likely to lead to lower rates of inflation and unemployment and a higher rate of productivity. Specifically, measures should be taken to increase labor mobility, modify the incomes policy, and reform the social benefit system. Some well-meaning statements had been made in that area, but they had been difficult to implement because they necessitated making drastic corrections to deep-rooted economic and social problems. The pursuit of necessary economic objectives could be gradual, but would have to be firm.

The public sector deficit reflected the consequences of Sweden's structural problems, Mr. Lovato observed. He agreed with the authorities' strategy to emphasize the curtailment of expenditures rather than any increase in taxation; he feared, however, that that strategy would be the most difficult to implement. For example, despite the expenditure cuts announced in October 1980 and February 1981, the growth in real public expenditures was estimated to have accelerated to 5 per cent a year. Given the nature of the social security system and the authorities' priorities, much of the increase in expenditure had resulted from rising unemployment; it had to be noted, however, that approximately 80 per cent of central government expenditures were subject to automatic increases. He wondered whether the authorities were aware of the limited scope of fiscal policy in the current situation, and whether they were planning to make structural changes in public sector expenditures.

He agreed with the authorities that tax reform was the key element in their plans to improve incentives and thereby the competitiveness of the economy, Mr. Lovato stated. However, in his view, only the reduction in the marginal tax rates was a clear supply-side measure. The other tax measures mentioned on page 7 of SM/81/201 could not really be referred to in that way; he would appreciate staff comments on that subject. Finally, with the exception of the points mentioned he could go along with the staff's appraisal.

Mr. Winkelmann considered that Sweden was at a crossroads. Its economy was characterized by severe underlying external imbalances, triggered by a loss of competitiveness and rigidities in domestic supply coupled with low fixed investment rates, and an increasing public sector deficit. At the same time, inflation was high but relatively controlled, unemployment was low, recent wage agreements had been moderate, and there had been an increase in personal savings. Most important on the favorable side was the gradual shift in public and government attitudes toward acceptance of a policy of adjustments that would not exclude some personal

sacrifices. Table 39 in SM/81/211 set out two scenarios for the Swedish authorities--one optimistic scenario assuming policy actions by the authorities, and one pessimistic scenario assuming no governmental action. In the optimistic scenario public consumption was projected to grow by 0.4 per cent, whereas in the pessimistic scenario consumption was projected to increase by 2.6 per cent. If consumption were to increase in that manner, gross fixed investment in mining and manufacturing would decrease by 5 per cent instead of increasing by 6.5 per cent, and the growth in exports of goods and services would be reduced to 2.6 per cent.

Sweden's low unemployment rate was a reflection of the priority given to employment by the Swedish authorities, Mr. Winkelmann said. The authorities envisaged taking steps to boost the labor market should the unemployment rate rise higher during the current year. He wondered whether that was advisable, because in the past such alleviating measures had tended to increase subsidies and to direct resources to uncompetitive sectors. The low unemployment rate had been made possible by a strong growth in public services. Unfortunately, the rate of productivity in public services was extremely low and the growth of manpower in that sector had crowded out private industry, particularly in the exposed sectors. The reduction in the average hours worked each week between 1970 and 1979 had contributed to the low unemployment rate. Increased absenteeism and longer holidays had also played a role.

He welcomed the moderate wage agreements that had been reached over the past year, Mr. Winkelmann continued. Wage agreements reached during 1981 were to be binding for two years and would involve a fall in real personal disposable income at least during 1981. However, the continued application of the "egalitarian wage policy" was leading to immobility in the labor force. Could the staff say whether immobility had also been affected by insufficient housing or other factors? The authorities had ensured moderate wage increases by reducing the value-added tax so as to avoid triggering cost-of-living increases, and by freezing prices for three months--an action that might create problems later if prices surged upward at the end of the freeze period. Taking into consideration the price freeze and the recent devaluation, he wondered whether the forecast inflation rate was not rather optimistic. He welcomed the exclusion of energy prices from the wage index, which would enable the authorities to pass through the price effects of increased energy prices. Could the staff say whether the present incomes policy would permit higher profits in the private sector, particularly in the exposed sector, so as to provide the additional needed incentives for investment?

Certainly the rate of private fixed investment had to be increased after its decline between 1976 and 1980, Mr. Winkelmann remarked. There seemed to be a propensity to invest in the Swedish economy, but the current level of investment was insufficient to increase productivity in the future. At present, it seemed more attractive to invest in monetary assets and thus finance the federal government deficit.

Real expenditure in the public sector had increased steadily over the past ten years and was now equivalent to almost 65 per cent of GDP, the highest ratio among OECD countries, Mr. Winkelmann noted. There was nothing wrong in a growing public sector, if it meant a demand for public service that could not be provided better and cheaper by private business. The problem in Sweden, however, was that public services were often monopolistic. Whereas a private enterprise providing services would go bankrupt if it incurred losses, a state bureaucracy was able to find a number of ways, both conventional and unconventional, to meet financing gaps--for example, higher taxes, central bank financing, or borrowing abroad. The total public budget had been in surplus until 1977 because of compensating surpluses in the social insurance system. Could the staff say whether there would be surpluses in the social insurance system over the coming five to ten years, or would there be problematic deficits there as well?

During 1980 the public sector deficit had risen and the tax base had not increased as fast as expenditures, Mr. Winkelmann commented. With a marginal state income tax of 85 per cent, and a value-added tax of over 20 per cent, there was no scope for increasing the share of taxes as a percentage of GDP. On the contrary, in view of the immobilizing effects of higher taxation on workers, managers, and entrepreneurs, and the shrinking effect it had on the exposed sectors, the Government's intention to reform the tax system over a period of two to three years beginning in 1983 was most welcome. Such a reform to improve the incentive structure and thereby the competitiveness of the economy was urgently required. He would be interested to hear the views of the staff and of Mr. Sigurdsson on the likely effect of the proposed reform. If the reform led to financing gaps in the public sector and to increasing imbalances in the economy on the domestic and external sides, it would be essential for expenditures to be reduced. Since approximately 80 per cent of central government expenditure was subject to automatic increases, there seemed to be no way avoid making some reductions.

Monetary policy could perhaps play a more active role in supporting the exchange rate and combating inflation, Mr. Winkelmann continued. The authorities had tried to tighten domestic credit policy during 1980/81, but the liquidity effects of high government borrowing abroad had limited its usefulness. Could the staff explain the role played by the "gray credit markets" in financing private credit demand? What share in deposits and credits did those markets hold? If those free markets had not existed, he assumed that short-term capital exports might have been much larger, reflecting the domestic imbalances and the rigidities in the interest rate structure. It was noticeable that none of the strong external shocks suffered since 1974 had been followed by adequate economic adjustment in Sweden. The output of the exposed sector had declined by some 7 per cent between 1974 and 1980, and Sweden's share in world export markets had declined accordingly. The country's current external surplus--equivalent to about 4 per cent of GDP--might not be sustainable in the long term; for example, debt servicing might create difficulties in the future.

The deterioration in the current account had been caused, inter alia, by the high absorption of the public sector, the low rate of investment, labor immobility, loss of competitiveness because of increasing wage costs, and the lack of flexibility in exchange rate policy. It was not certain that competitiveness had been restored by the courageous depreciation of September 1981. It had to be remembered that after the devaluation of 1977, exporters had increased their domestic prices in order to increase profits. He wondered whether the forecast of 8 per cent volume growth in exports was not rather overoptimistic during a period when world trade growth was unlikely to exceed 4-5 per cent. It seemed obvious that to bring about growth and more domestic and external stability public attitudes would have to be changed. Although gradual policy actions might not be damaging, a more vigorous policy seemed called for. If the Swedish authorities could push ahead successfully with an adjustment program, they could serve as an example to their colleagues in other countries that were facing similar problems.

Miss Le Lorier noted that Sweden was beset with several complex economic problems, notably a disappointing tendency toward a suboptimal use and allocation of resources, domestic and external imbalances, and a lack of factors mobility. There were, however, a number of positive elements that justified some measure of optimism for the future: the devaluation of the krona in September 1981 had had beneficial effects on external competitiveness; inflation had been reduced significantly from 14 per cent in 1980 to about 10 per cent in 1981 with prospects of a continuing decline; the level of wage settlements had moderated; and the current account deficit had fallen to the equivalent of 3.3 per cent of GDP and was expected to fall further to 3.2 per cent in 1982. The question facing the authorities was how they should proceed to tackle the country's more fundamental structural difficulties. She supported their view that stabilization efforts should be implemented in a medium-term program of about five years. It was noteworthy that the change of government in May 1981 had not affected the medium-term strategy for 1980-85, with the exception of a postponement to 1983 of the proposed income tax reform.

She wondered about the implications for future policy actions of maintaining the objective of reducing the central government deficit by an amount equivalent to 1 per cent of GDP annually, Miss Le Lorier continued. Did the authorities intend to adopt a more restrictive stance to achieve the overall objective of bringing the ratio of that deficit to GDP to 5 per cent by 1985? If so, an annual reduction of 1 per cent might not be adequate, since the expected deficit for 1981 was equivalent to 13 per cent of GDP. Could it be assumed that the fiscal balance was moving in the direction of the second, pessimistic alternative in the medium-term survey and a deficit of 12 per cent of GDP in 1985? In view of the strong link observed in the past between the public sector deficit and the current account deficit the realization of the pessimistic scenario would have serious implications for the authorities' major objective of returning to sustainable balance of payments deficits. The 1981 current account deficit, equivalent to 3.3 per cent of GDP, already appeared uncomfortably high in comparison with other industrial countries; delays in achieving

a better balance would probably prove to be a major setback and reduce further the authorities' margin of maneuver.

The comparative advantages won by the September 1981 devaluation and the favorable outlook for prices and wages should be fully exploited, Miss Le Lorier recommended. She wondered, however, whether the authorities might not have been rather overoptimistic in their assessment of external prospects and their view that a revaluation of up to 4 per cent of the krona could be considered as a possible means of limiting the effects of international price increases on domestic prices. She had considerable hesitation in accepting that such a revaluation would provide an extra incentive to exporters to improve their price competitiveness. The trends in profit margins in manufacturing and in export performance over the past years tended to suggest that the recent devaluation had been an essential element of the strengthening of the export sector and that exporters would be more inclined to keep their profit margins at a level consistent with market conditions and with their investment plans. The likelihood of such an approach seemed to be reinforced by the speed with which capacity utilization limits had tended to be reached as a consequence especially of insufficient labor mobility. That lack of mobility, within a context of generally high supply rigidities, might ultimately prove to be the main obstacle to adjustment that the authorities would have to face. In that context, it should be noted that wages in the public sector had increased more rapidly than in the private sector and that wage differentials in industry had narrowed. It was also significant that following the continued growth of the share in the economy of the public sector in relation to the exposed sector, there would seem to be less scope for improving labor mobility or making significant shifts in resource allocation.

The continued expansion of government spending--which would increase again by 5 per cent in real terms during 1981--reinforced the view that the limitation of the public sector deficit was the most important objective, Miss Le Lorier remarked. Accordingly, the growing awareness of the authorities and of the trade unions of the need for stringent expenditure control and for more moderation in wages and social transfers was welcome. Could the staff comment on the preliminary forecasts of possible improvements in the fiscal field in 1982/83? Could it say whether the possibility of the Swedish economy developing along the lines of the first, optimistic scenario had improved recently?

Mr. Taylor said that he agreed with the staff's appraisal of the Swedish economy. He agreed, in particular, that the authorities needed to take action to tackle the three major problem areas identified in their medium-term survey--competitiveness, incentives, and the overlarge public sector. The difficult task facing the authorities was to determine how to achieve the right degree of forceful action. Obviously, it would be foolish to ignore the broader social and political considerations that so frequently delayed and complicated economic adjustment; but even making due allowance for the need for gradualism, progress over the past year pointed to the need for a stronger and more forceful approach to adjustment through determined demand management and supply-side policies.

With regard to fiscal policy, Mr. Taylor suggested, the most vital need was for some reduction in the weight of the public sector. The proportion of tax revenues to GDP, at about 50 per cent, was already too high, so that action should be focused more on containing expenditure than on increasing tax rates further. The continued growth in public expenditure in real terms despite the rather slow growth of the overall economy gave grounds for concern. The authorities were certainly aware of the importance of containing the fiscal deficit, but he wondered whether their aim of reducing it as a proportion of GDP by only 1 per cent a year reflected a sufficiently rapid adjustment effort. Did the staff believe that there was scope for more rapid fiscal adjustment? For example, should the comprehensive automatic increases in central government expenditure be limited?

Central government transfers to local authorities had also continued to increase, partly as a result of increased subsidies to restrain local tax rates, Mr. Taylor continued. While welcoming the recent changes in the financial relationship between the Central Government and the local authorities, he wondered whether there might be scope for placing a greater degree of responsibility for revenue raising on the local authorities. It would be valuable if the process of making decisions on revenue and on expenditure could be better integrated; better integration at the local authority level would encourage more responsible decisions on expenditure priorities.

The Central Government's present borrowing requirement was placing a considerable strain on monetary policy and risked crowding out the private sector, Mr. Taylor observed. He agreed with the staff that an increase in the currently negative levels of real interest rates would bring the burden of running the large fiscal deficit more into the open and would help to enhance domestic savings. The recent partial liberalization of interest rate policy was welcome, although further steps in that direction should probably be taken. Reducing interest rate subsidies at the same time would, presumably, strengthen the overall fiscal position.

There was a need to expand the exposed private manufacturing sector of the economy, Mr. Taylor recommended. The devaluation of September 1981 should help to shift resources to the external and the exposed sectors by helping to reverse the serious loss of international competitiveness, and thus pave the way for an improvement in the trade balance and a reduction in the current account deficit. However, it seemed that supply-side constraints had prevented the realization of the full advantages of the 1977 devaluation; he wondered whether that experience would be repeated.

The centralized system of wage bargaining was a potential obstacle to necessary adjustment, Mr. Taylor said. The slower growth of wages achieved during 1981 was encouraging, although the latest agreements negotiated included a form of wage indexation that was unrelated to the competitive situation and that might have undesirable consequences. Certainly the fact that pay in the public sector was expected to increase by about 8.5 per cent while pay in the private sector was expected to

increase by only 7.5 per cent was hardly consistent with the desire to shift labor into the exposed sector. He wondered what future wage trends would be and whether future public sector wage increases might be more moderate in relation to increases in the private sector.

The buildup of external indebtedness was a source of particular worry, Mr. Taylor said. The Swedish economy continued to enjoy a favorable credit rating and the country's level of official foreign indebtedness was still low by international standards. However, that indebtedness had grown rather rapidly in recent years; it had in fact quadrupled since 1977 at least in nominal terms. A further protracted recourse to foreign borrowing at such levels could, in due course, endanger Sweden's prime credit rating in international capital markets.

Mr. Nagashima expressed agreement with the general thrust of the staff appraisal. It seemed clear that the Swedish economy was characterized by a number of structural imbalances. The overall deficit of the public sector had been steadily increasing since 1977, both in absolute terms and in relation to GDP. Moreover, the public sector was taking an increasing share of the resources of the economy. The shift of labor from declining to expanding sectors in industry had been inhibited by narrow wage differentials, and structural adjustment had been delayed by supply rigidities. The current account deficit, excluding official transfers, had been rising since 1979. Net foreign debt was steadily increasing, and there had been a large deterioration in net interest payments.

In spite of its problems, the Swedish economy had, however, made some progress on several fronts, Mr. Nagashima continued. Wage settlements for 1981/82 had been relatively moderate; the rate of inflation had decelerated and was likely to continue doing so; and the devaluation of the krona in September 1981 was expected to have a positive impact on the volume of exports over time and contribute to a modest growth in 1982. Despite the positive elements in the economy a difficult task of structural adjustment remained to be undertaken.

He hoped that the authorities would continue to adhere to their objective of reducing the central government deficit to 5 per cent of GDP by 1985, from 13 per cent in 1981, Mr. Nagashima said. A substantial reduction in expenditures was essential to achieve that goal. It was encouraging to note that the authorities had been scaling down expenditures on industrial support, which had hampered structural adjustment in the past. In comparison with the Central Government, local governments had comfortable liquidity positions, and the staff had expressed some concern as to whether their growth of expenditure over the previous year would be limited to the projected level of 1 per cent. He hoped that the proposed cuts in transfer payments from the Central Government to the local authorities would have the effect of restraining growth in overall public expenditure.

On the supply side, he welcomed the authorities' intention to undertake tax reforms, to reduce marginal tax rates gradually, and to strengthen

the incentive structure, Mr. Nagashima indicated. Care needed to be taken, however, that revenue losses resulting from the reform would be offset by other measures. In that context, he would appreciate some information from the staff as to when the projected tax reforms that were now expected to be introduced in 1983 would come into effect. As to wages policy, he was concerned that public sector employees had received a higher increase in hourly earnings than employees in the private sector. Relatively high wage increases in the public sector might well have reinforced claims from the private sector for similar increases, which would pass beyond productivity gains. He hoped that in future wage settlements more moderation would be observed, particularly in the public sector. Perhaps the authorities should make attempts to convince the public of the undesirable effects egalitarian wage policies would have on work incentives.

The authorities should follow up the recent devaluation of the krona with additional complementary policy measures, Mr. Nagashima recommended. A tight monetary policy would need to be maintained through increases in interest rates and restraint on credit, particularly since the money supply was expected to rise faster than nominal GDP in 1981. Since the authorities had undertaken a policy of financing a current account deficit through government borrowing, the upward pressure on domestic interest rates had been restrained and the rates had been held lower than might have been expected. Since such a policy might slow down the needed structural adjustments by reducing the burden of financing large government deficits, he concurred with the staff that consideration should be given to freeing interest rates on private lending as well as on deposits. In that context, he would like the staff to explain why the official discount rate had recently been lowered.

Mr. de Vries remarked that there seemed to be four crucial problems facing the Swedish authorities: the level of government expenditures; the low level of profits; low labor mobility; and the inadequate monetary policy. The level of government expenditure, now equivalent to about two thirds of GDP, was a major burden on the country's economy. It was evident that such a high level was unsustainable for an economy of Sweden's type. The authorities had recognized that fact and had implemented policies over the past two years to contain the growth of public expenditure and the public sector deficit. Unfortunately, their efforts had not met with complete success because despite expenditure cuts announced in October 1980 and February 1981, real public expenditure had grown by 5 per cent during 1981 with little growth in real GDP. While the objective of reducing the growth in public expenditure by 1 per cent a year was less than could be hoped for, it would still represent an improvement on the present situation. One problem that had to be attacked with some urgency was the authorities' acceptance that about 80 per cent of central government expenditure was subject to automatic increase. Firm action on cutting back on government expenditures was essential because developments in that area affected the rest of the economy.

A country's GDP could be used in three basic ways: it could be spent by the government; it could be spent on investment; or it could be

consumed as freely disposable income, Mr. de Vries observed. If the amount spent by the Government rose, pressure would be placed on freely disposable incomes and there would be little room for any increase in profits. Another obstacle to structural adjustment in Sweden was the low level of labor mobility. The present egalitarian incomes policy and the tendency of public sector wages to rise faster than wages in the private sector encouraged static conditions in the labor market or even movement in the wrong direction.

Too little attention had been paid by the authorities to the effect of the government deficit on liquidity creation, Mr. de Vries considered. It made no essential difference to the rate of liquidity creation whether the Government financed its deficit by recourse to domestic credit and domestic money creation, or to foreign credit. If the Government borrowed abroad the proceeds would be sold to the central bank and would result in the same increase in money supply as if the Government had borrowed domestically. Of course, the central bank would have claims on the foreign sector rather than claims on the Government, but those claims on the foreign sector would be used to finance the current account deficit and so the system would continue. In short, Government borrowing both from abroad and from the domestic monetary sector resulted in an increase in liquidity. Sweden's large government deficit had, therefore, made it impossible to follow an appropriately restrictive monetary policy. The size of the government deficit at the moment was most troubling. Incidentally, it was questionable whether a rich country such as Sweden should be accumulating a large foreign debt in a world in which so many countries had great need for international savings.

Both the staff and Mr. Sigurdsson seemed to hope that the devaluation of September 1981 would have a positive effect on the economy, Mr. de Vries noted. It should be remembered that the 10 per cent devaluation of the krona in August 1977 and the moderation of wage agreements in 1977/78 had made only temporary improvements to the external balance because of the continued expansion of the public sector. He hoped that that experience would not be repeated. If the most recent devaluation was to be effective, it would have to be supported by domestic measures affecting the budget, monetary policy, and wages policy. He had not been fully reassured by the reduction in value-added tax that the authorities had introduced in connection with the devaluation. He understood that the value-added tax was not levied on the exposed sector--in other words those industries that exported or were subject to import competition. In conclusion, he hoped that the Swedish authorities would ensure that their policies were consistent with a general strategy of achieving satisfactory economic growth while reducing the external deficit.

Mr. Nimatallah remarked that for some time Sweden's primary objective had been the achievement of full employment and the improvement in social services through the expansion of the role of the public sector in the economy; those objectives had not always been compatible with external competitiveness and the result had been recurring pressures on the balance of payments. The Swedish krona had been devalued in 1977 as a means of

tackling the balance of payments problems at that time. However, that devaluation had not been accompanied by measures to limit the growth in the public sector or to reduce rigidities on the supply side, so Sweden's competitiveness had not improved.

As a result of an increasing awareness of the basic problems underlying the country's economy, the authorities had adopted in April 1981 a medium-term economic strategy, which had survived the changes in political leadership in May 1981 without significant modification, Mr. Nimatallah observed. The objectives of the medium-term strategy were to increase the competitiveness of the exposed sector, to remove certain flexibilities in the capital and labor markets, and to reduce gradually the excessive burden of the public sector in the economy. The strategy constituted a step in the right direction and the authorities should be encouraged to pursue it with determination.

The devaluation of September 1981 and the economic policy package adopted following the devaluation were good examples of the implementation of the new strategy, Mr. Nimatallah continued. The depreciation had helped to restore some competitiveness, and the tax policies that had been implemented, or had been proposed, following the depreciation would help to minimize its inflationary impact on the economy. Those policies should help to reduce the inflexibilities in the capital and labor markets and improve the competitiveness of Swedish industries. In the long term, expansion in the exposed sector of the economy could not be achieved without a reduction--however gradual it might be--in the share of the public sector in the economy. That was why the Government's determination to reduce gradually the size of the deficit in relation to GDP was so important.

He agreed with the staff's assessment that if the optimistic assumption of the medium-term strategy of reducing the ratio of fiscal deficit to GDP to 5 per cent by 1985 was to be achieved, a more restrictive policy on expenditures than was now envisaged should be pursued, Mr. Nimatallah remarked. That was particularly so in light of the recent trend toward the reduction of taxation. On monetary policy, he did not agree fully with the staff assessment that raising domestic interest rates would serve a useful purpose. The rate of inflation in Sweden did not seem to warrant such action. If consumer prices were expected to increase by 10 per cent during 1981, it would appear that current interest rates were already positive in real terms; comments from Mr. Sigurdsson or the staff on that point would be welcome. While raising domestic interest rates might have some beneficial effects, it could also have adverse effects on investment and growth. Interest rates could be used as tools for achieving several objectives, for example, to encourage or discourage savings, spending on investment and consumption, capital outflows or inflows, or changes in other magnitudes and economic variables. He could not agree with the staff that interest rates should be raised until the effects of such an action on all of those areas had been analyzed.

He commended the Swedish authorities for their official development assistance policies, Mr. Nimatallah concluded. Despite their budgetary and balance of payments problems, the authorities had set themselves a goal of making available 1 per cent of their GNP for official development assistance. In recent years they had not been very far from that target.

Mr. de Groote commented that Sweden's present situation deserved even more attention than usual. Sweden shared its problems with many other industrial countries that were experiencing similar difficulties in adjusting to changes in the terms of trade, because the rigidities of wage determination and social security systems delayed the necessary transfer of resources from internal absorption to balance of payments financing. Traditionally Sweden's adjustment strategy had been to depreciate the krona in order to re-establish the competitiveness of the export sector; to adopt simultaneously corrective measures affecting public finance, investment, and incomes policies; and to counteract the initial effect on employment by specific labor market measures. Overall, that strategy seemed to have been correct. He doubted, however, whether the intensity of the corrective measures now being adopted was sufficient.

He welcomed the authorities' use of the traditional tool of exchange rate adjustment, Mr. de Groote said. Relying exclusively on a gradual readjustment without the initial shock of the devaluation would have made the adoption of the accompanying corrective measures more difficult and lengthy, and would have imposed a prolonged deflationary period with difficult political repercussions. It was interesting to note that the characteristic feature of the adjustment program was that it was not deflationary in its general orientation and that the authorities hoped to improve public finances by maintaining a relatively high rate of growth in income and by introducing selective measures for acting on unemployment.

The chances for the success of such a program would depend essentially on the central issue of the relationship between prices and labor costs in the exposed sectors, Mr. de Groote observed. Those relationships determined profitability of the export sector, the possibilities for investment, and the level of employment. They also determined the results of price-wage developments in the sheltered sector. It was very important, therefore, to avoid price and wage developments in the sheltered sector that did not take into consideration developments in the exposed sector. The Swedish authorities believed that actions on prices could be taken through exchange rate adjustments and actions on wages through wage negotiations and fiscal measures. However, the success of the program would depend on the authorities' ability to reduce sufficiently the absorption of the value added by enterprises into wages and transfers.

There were four points on which he had reservations in the authorities' program, Mr. de Groote continued. First, it was a matter of concern that real growth in public sector expenditure was expected to remain substantially higher than growth in GDP. It was not easy to see how Sweden could easily achieve the necessary transfer of real resources

from internal absorption to the balance of payments. Second, the consumer price index had been contained below 10 per cent during 1981 and was projected to remain at 6.5 per cent or 7 per cent over the coming year; those figures might represent an underestimation of the J-curve effects of devaluation as well as the effect of some proemployment measures. If that were so, it was probable that the indexation system would unlock adjustments in wages that in their turn might jeopardize the necessary transfer of real resources to the balance of payments.

Third, Mr. de Groote went on, although Sweden had held to a tight monetary policy throughout 1981, the money supply had risen faster than in previous years, and might lead to an increase in the consumer price index that would unlock increases in salaries that would, in turn, make the transfer of real resources to the balance of payments impossible. Fourth, the measures adopted to increase supply through investment obviously acted rather slowly, and it could not be seen from the staff papers that they would have any significant effect over the coming two years. In that case, the fundamental balance between supply and demand in the Swedish economy might not be achieved and restructuring absorption might be extremely difficult. Finally, he commended the Swedish authorities for the high percentage of GNP they made available as official development assistance. The authorities had not reduced their assistance to the developing world as one of the means to readjust their balance of payments; that rather unique fact could be used as an example by other industrial countries.

Mr. Erb said that he shared the view of some previous speakers that the Swedish authorities should place emphasis on the reduction of the relative size of government expenditures. There were a number of areas that seemed ripe for greater constraint: transfers to local authorities, subsidies to inefficient industries, unemployment benefits, and public sector wages. Adjustment in those areas, in addition to reducing the magnitude of government expenditures, would lead to a more fluid and rapid movement of resources into the external sector. As others had pointed out, the greater mobility of resources within the Swedish economy was vitally necessary. On the revenue side, he wondered whether the Government's intention to compensate for proposed tax reductions through a payroll tax or a tax on production would conflict with the need for improving the external competitiveness of the exposed sector.

The budget deficit would have to be reduced if the rate of growth in money supply was to be checked, Mr. Erb commented. The rate of growth of money had been excessive and, even though there had been a reduction in inflation, it could contribute to inflationary problems in the future. In that context, he had noted with interest the staff's comment that because of the lower central government deficit the level of money growth had been better than expected.

He agreed with previous speakers that impediments to interest rate flexibility on long-term securities had limited the authorities' ability to finance the government deficit outside of the banking system and had

thus generated pressures for greater money growth, Mr. Erb continued. Allowing interest rates to move more rapidly in line with market rates would increase the authorities' ability to control money growth and improve the allocation of resources.

Most observers seemed to agree on the major problems facing the Swedish economy, Mr. Erb noted. Certainly the staff and the Swedish authorities had identified the same major policy initiatives that needed to be taken. Like Mr. de Groote, he had the feeling that the speed and the intensity of actions planned were not sufficient to bring about the necessary level of adjustment. Looking at the economy from an external perspective, it seemed obvious that the speed of adjustment within the domestic economy would be critical to the promotion of greater external adjustment. He shared Mr. Taylor's concerns about Sweden's external debt situation. Sweden had a high credit standing, but if the rate of growth of the government deficit continued at such a rapid pace, it could undermine the country's creditworthiness and thus increase the cost of credit. Equally important, if there were a reduction in the perceived creditworthiness of Sweden there might be a potential ripple effect on the international financial system as the general uncertainty about the abilities of countries to manage their external position increased. The question would be asked: If a country of Sweden's wealth and ability to manage its affairs could not escape from excessive debt accumulation and reduced creditworthiness what would be the chances of other countries doing so?

Mr. Joyce remarked that the problems arising from the deep-rooted structural rigidities in Sweden's economy could clearly not be resolved rapidly. Other countries, shared many of Sweden's problems, notably the inability to afford to support for much longer a comprehensive system of social benefits. That inability posed particular difficulties for democratic societies, where the authorities had to try to meet the expectations of the electorate. Moreover, it was particularly difficult to envisage adjustments or cutbacks in social benefits at a time when unemployment was rising and was likely to continue doing so.

He welcomed the steps already taken by the authorities, such as the recent devaluation and the changes that were beginning to be made in monetary policy, fiscal policy, and industrial policy, Mr. Joyce said. Change in all of those areas was essential if the authorities were to encourage a better allocation of resources and to strengthen the more competitive sectors of the economy. He shared the concerns of some previous speakers with the high level of wage settlements in the public sector and the continued increase in public expenditures. The problems in the private sector where egalitarian wage tendencies were inhibiting mobility between the sheltered and exposed sectors also gave grounds for some concern. He wondered whether the authorities were doing enough to strengthen fiscal policy, and whether monetary policy was sufficiently flexible, particularly with regard to the level of interest rates.

Sweden's difficulties were certainly not short term in nature, Mr. Joyce remarked. Fundamental structural changes in the economy were called for--changes that would be difficult to bring about in the present international economic climate. To achieve success in an adjustment program it was essential that the public be brought to recognize the real nature of the problems facing the country and show some willingness to accept measures that were unlikely to lead to higher growth or lower unemployment in the immediate future. Some previous speakers had questioned the advisability of the Swedish authorities' gradual approach, and had suggested that more rigorous policies in the management of demand and supply might be appropriate. He shared those concerns, but believed that judgments on the tempo of change had to be made by the national authorities; they were in the best position to know what changes could be publicly acceptable. Apparently the authorities had noted a growing awareness among the general public of the true nature of the country's problems; what they now had to determine was how deep and how widespread that awareness was, and whether there was a social consensus that would support more rigorous attacks on economic problems. Mr. Sigurdsson's comments on that question would be interesting.

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

APPROVED: March 29, 1982

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Secretary