INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/104

10:30 a.m., June 27, 1986

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	Mawakani Samba
	D. C. Templeman, Temporary
	H. G. Schneider
	M. Z. M. Qureshi, Temporary
	M. Sugita
	A. Bertuch-Samuels, Temporary
	Wang X., Temporary
J. E. Ismael	
	J. R. N. Almeida, Temporary
	M. Foot
	R. Fox, Temporary
H. Lundstrom	
	L. Leonard
	A. Abdallah
	P. E. Archibong, Temporary
F. L. Nebbia	
	J. E. Suraisry
	L. P. Ebrill, Temporary
P. Pérez	
	S. de Forges
J. J. Polak	
C. R. Rye	
	O. Kabbaj
A. K. Sengupta	A. Vasudevan, Temporary
S. Zecchini	N. Kyriazidis

L. Van Houtven, Secretary
L. Collier, Assistant

Also Present

European Department: B. Rose, Deputy Director; A. L. Bovenberg, M. T. Hadjimichael, R. G. Thurmann, H. Vittas. Exchange and Trade Relations Department: J. T. Boorman, N. Streefkerk, P. J. Quirk. Fiscal Affairs Department: A. A. Tait, Deputy Director. Legal Department: F. P. Gianviti, Director; J. G. Evans, Jr., Deputy General Counsel; R. H. Munzberg. Research Department: W. C. Hood, Economic Counsellor and Director; R. R. Rhomberg, Deputy Director; J. Folkerts-Landau. Secretary's Department: J. W. Lang, Jr., Deputy Secretary. Treasurer's Department: E. Decarli. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: G. Nguyen, P. Péterfalvy, M. A. Weitz. Assistants to Executive Directors: B. Bogdanovic, J. de la Herrán, F. Di Mauro, W. N. Engert, V. Govindarajan, G. K. Hodges, T. Morita, A. H. Mustafa, J. Reddy, J. E. Rodríguez, S. Simonsen, H. van der Burg, B. D. White.

1. NEW ZEALAND - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with New Zealand (SM/86/112, 5/22/86; Cor. 1, 5/28/86; and Sup. 1, 6/25/86). They also had before them a report on recent economic developments in New Zealand (SM/86/124, 6/9/86).

Mr. Rye made the following statement:

Since its election in July 1984, the New Zealand Government has initiated, and largely implemented, comprehensive and far-reaching economic reforms. My authorities welcomed the opportunity to review with the staff the progress they have achieved so far, and their future policy intentions. They are in broad agreement with the staff on all the major issues, and regard the report as an accurate and comprehensive account of recent developments in the New Zealand economy and economic policy.

It may be useful to outline the basic framework that has guided New Zealand economic policy since July 1984. This has been two sided: to undertake necessary macroeconomic adjustment and, of no less importance, to promote microeconomic reforms aimed at improving efficiency, resource allocation, and flexibility in the economy.

Within this framework the Government has achieved a significant reduction in the fiscal deficit--from 8.9 percent of GDP in 1983/84 to 4 percent of GDP in 1985/86--enforced a firm monetary policy by fully financing the fiscal deficit through domestic bond issues, deregulated the financial sector, floated the exchange rate, substantially reduced government assistance to the export sector--including agriculture--and accelerated the rollback of protection from imports. Additionally, a major restructuring of the tax system--the introduction of a value-added tax and reductions in personal income tax--will take effect on October 1, 1986, substantial reforms to the public sector have been announced, and it is expected that decisions will be taken on labor market reform by about the end of this year.

Most of these policy measures have both a micro and macro dimension. For example, financial deregulation, a prerequisite for implementing a firm monetary policy, is also contributing to improved resource allocation in the economy. Similarly, the public sector reforms and measures to reduce government net spending--as described in the supplement to the staff report--will carry benefits for both the fiscal balance and public sector efficiency.

In some areas there are tensions between the different elements of the overall strategy. In particular, substantial costs to the budget are likely this year as a result of losses being incurred by, and restructurings of, the major industrial and energy projects initiated, with sponsorship by the then-Government, in the early 1980s. While it would have been possible to mask these costs by sheltering these projects from the changed conditions they now face, this would have introduced distortions into the economy and, in all likelihood, led to misallocation of resources. Another legacy from the past limiting the scope for further improvement in the fiscal position this year is the need to tackle the large debts, accumulated under previous policies geared to supporting farm incomes, of the primary producer boards.

The Government has also had to face the release of pressures built up during the wage-price freeze of 1982-84, which was particularly evident in the 1985 wage round. Consistent with the medium-term focus of the overall strategy, the Government refrained from intervening directly in the round so as not to undermine the development of a more flexible wage-fixing process. While the outcome in terms of the average increase in wages and salaries was disappointing to the authorities, the short-term adverse effects were less than might have been feared. Some diversity in settlements has been achieved--although mainly, but not entirely, in above-award payments--and the flow-on to prices has been limited owing to the generally high profit base of employers, greater exposure to competition from imports, and the Government's nonaccommodating macro policies.

Wages and salaries increased even more in the public sector than in the private sector. While this in part reflects a catch-up with the private sector from the 1984 wage round, and serious recruitment and retention problems in some areas, the magnitude of the increase also reflects deficiencies in the state pay-fixing mechanisms. These are being addressed; a committee reviewing state pay fixing is about to report, and the introduction of more flexible pay-fixing arrangements for state-owned enterprises is envisaged in the recently announced public sector reform package.

This year's wage round will be negotiated in a more helpful environment. Since the 1985 round, the Government has demonstrated its full commitment to nonaccommodating macro policies, the economy is more subdued--GDP is expected to fall by about 1 percent in 1986/87--and the negotiating parties should have learned some lessons from the last round, reinforced by lower business profits and rising unemployment. The Government again intends not to provide a guideline for the round so as to avoid any notion of a government-endorsed going rate or ceiling, which would most likely become a floor. The prospect of a major reform of labor market institutions to facilitate more flexibility in wage and salary determination processes may have a helpful influence.

There are also grounds for some optimism about the inflation outlook. After increasing sharply in 1984--reflecting the lifting of the price freeze, devaluation of the exchange rate, and increases in charges for government-provided goods and services, inflation is now trending downward. Food prices fell in May by 0.2 percent, and two major independent economic forecasting groups have recently revised their forecasts of inflation for the year to September 1986 from about 12 percent to 10 percent. Following the downward trend in inflation--and inflation expectations--interest rates have fallen considerably. Ten-year government bond rates are now about 15 percent, compared with rates of about 19 percent early this year. These developments have seen the exchange rate weaken somewhat in recent weeks, and should lead to some easing of the pressures borne by the tradables sector during the past year.

The staff report notes that the gains in external competitiveness achieved in 1982-84 have since been largely eroded. This reflects the wage and price developments outlined earlier and upward pressure on the exchange rate. While unhelpful in some respects, the pressure on the exchange rate has been regarded as one of the inevitable consequences of the disinflation process. It has not therefore been regarded as cause for relaxing the underlying stance of monetary policy or for intervention in the exchange market to lower the rate, which would in any case have been unhelpful for monetary policy. Rather, my authorities consider that a broader approach is required--one that emphasizes the need to ease the burden of adjustment on the export sector by removing inappropriate government intervention sheltering the rest of the economy.

My authorities therefore agree with the staff that additional reforms at the microeconomic level--especially in the labor market, in the public sector and through further reductions in protection--and further progress on the fiscal deficit are the best ways to reduce the costs of the adjustment process. The key will be to maintain an overall balance in the strategy--to ensure that the pace of reform in the easier areas does not outstrip that in the more difficult ones--while keeping the momentum of reform going. In the more difficult areas the Government must take time to build a constituency for change if it is to be successful in achieving permanent reform.

Regarding the balance of payments, the current account has not narrowed to the extent that was expected a year ago, mainly because domestic activity remained strong in 1985 longer than expected. The continuation of a current account deficit--albeit according to the latest forecasts a substantially smaller one in 1986/87 than in 1985/86--needs to be viewed against the more attractive environment for foreign direct and indirect investment in New Zealand and the floating exchange rate.

At the same time, the short-term outlook for the important farm exporting sector remains difficult. In part this reflects the withdrawal of assistance to the agricultural sector, but deteriorating returns for primary commodities caused by oversupply in important markets have been a major problem. Despite the difficulties, the Government has strongly resisted a return to policies that would insulate the agricultural sector from market signals.

In summary, the New Zealand Government has set in place a strong and integrated medium-term program of macrostabilization and structural adjustment. This has involved short-run costs, but the first benefits are now beginning to emerge. Current indicators suggest only a shallow recession and the likelihood of some upturn in activity toward the end of this year. While there will be occasional setbacks, the Government remains strongly committed to maintaining the overall momentum of reform.

Mr. Ismael recalled that on the occasion of the discussion for the previous Article IV consultation with New Zealand (EBM/85/93, 6/10/85), the Executive Board had expressed its full support for the general economic strategy of the authorities. In particular, the Board had endorsed the authorities' strategy to reduce the budget deficit, reform the tax system, decontrol interest rates and exchange rates, reduce protection to local industry against imports, and, more generally, move away from regulation and controls toward reliance on market forces. The present discussion provided an opportunity to review the progress in the implementation of that economic strategy, to assess the results achieved thus far, and to identify areas where further measures might be necessary.

The stance of fiscal policy was appropriate, and significant progress had been made in reducing the budget deficit, Mr. Ismael noted. However, the pace of fiscal adjustment in 1985/86 was somewhat slower than originally budgeted, primarily owing to two factors: large salary increases to civil servants and higher than expected debt service costs.

Looking ahead at 1986/87, it appeared that in the absence of additional measures to reduce expenditures and raise new revenues, the fiscal deficit could rise substantially, Mr. Ismael continued. He shared the staff's concern that the large public sector pay increase, together with the slippage in the implementation of the 1985/86 budget, would have the effect of lifting the base for most items of expenditure and for the deficit. The fiscal outlook for 1986/87 was not promising, and he did not see any evidence of a serious plan to tackle the problem. The staff reported that a Cabinet Committee had been established to identify potential areas of savings in public expenditures, but it went on to state that the Committee was engaged largely in cosmetic operations to shift certain expenditures out of the public account. His chair was of the view that the ongoing review would have to transcend cosmetic measures and make a more serious effort at cutting public expenditures so that a sustainable fiscal position could be achieved. Expenditure reduction was the only viable way in which the fiscal deficit could be reduced, as taxation was already high at about 35 percent of GDP. If higher taxation were to be considered as a means of reducing the fiscal deficit, the authorities would have to proceed carefully and implement tax increases selectively in a manner that would not adversely affect incentives.

In an economy like that of New Zealand, where indexation of incomes had become entrenched and pervasive, the choice of the tax instrument was important, Mr. Ismael commented. Several theoretical arguments existed as to why an expenditure-based tax system was better than an income-based one and why a wider tax base was better than a narrower one. In New Zealand, where wage rates were linked to prices, indirect taxes--compared with direct taxes--added to inflation both directly and indirectly, made exports less competitive, and worsened the fiscal situation. The 10 percent goods and services tax was not a reform measure because, to the extent that it would be used to offset lower personal income tax rates, it could be considered a backward step; he asked for the staff's views on that matter.

The staff appraisal of monetary policy was somewhat inadequate, Mr. Ismael remarked; while describing the authorities' policy, the staff had failed to pass a clear judgment on its appropriateness. For example, the staff had stated that the authorities would pursue a nonaccommodating monetary policy and that they would finance the borrowing requirement of the public sector from noninflationary sources. But the actual monetary developments shown in Table 2 of the staff report indicated that in December 1985 total credit growth had been 28 percent a year, credit to the Government had grown by 24 percent a year, and broad money had increased by 20 percent. Latest data for March 1986 showed that total liquidity growth had accelerated to about 24 percent a year. Given those magnitudes, he tended to conclude that monetary policy was expansionary and that measures should be taken to reduce the rate of money growth. He asked the staff for its views on monetary developments and whether it considered that actual developments were consistent with the authorities' objectives of attaining domestic and external stability.

Liberalization of interest rates was a welcome feature of monetary management, Mr. Ismael considered. It was understandable that the authorities were unwilling to tighten monetary policy because in the short run it would raise already high interest rates. However, there was little doubt that interest rates would remain elevated so long as inflation remained high. Therefore, it was all the more important that macroeconomic policies, as well as incomes policy, aimed to reduce inflation; in that respect, monetary policy had a key role to play.

The importance of incomes policy in New Zealand could not be overemphasized because it was such a significant determinant of the outcome of fiscal, monetary, and external developments, Mr. Ismael noted. It was unfortunate, although understandable, that recent wage developments had neutralized the positive effects of the wage freeze in the previous year.

That tendency for incomes to catch up suggested that legislative control on wages had little effect in controlling costs in the long run. Hence, firm financial policies, institutional and regulatory reforms to improve the workings of the labor market, and measures to open up the economy to foreign competition could lead to greater moderation in future wage settlements. He hoped that the authorities would pay greater attention to reforms in those areas so as to allow the market forces to play a more important role in wage determination.

He welcomed the fact that the authorities had initiated discussions on a new arrangement under which wage settlements would be linked more closely to general economic conditions and to the circumstances of individual firms, Mr. Ismael said. In the New Zealand environment, excessive reliance on macroeconomic policies might not be appropriate because, as New Zealand was a welfare state, any unemployment generated through tighter financial policies would only increase pressure on government expenditures for unemployment benefits and job programs. For that reason, incomes policy should be an integral part of the policy package; he hoped that the authorities and trade unions could agree on a more satisfactory system of wage determination.

In the external sector, the current account deficit had declined to 6.2 percent of GDP in 1985/86 from about 7 percent in 1984/85, Mr. Ismael observed. That improvement was welcome; however, the projected current deficit of 3 1/2 percent for 1986/87 seemed to be too optimistic in view of the sharp appreciation of the real exchange rate, the high expected wage settlements, and the poor prospects for commodity prices. The export sector was likely to be particularly affected by those adverse developments, especially at a time when the Government was withdrawing support from that sector. Therefore, the authorities should monitor both exchange rate developments and export sector profitability to ensure that they were consistent with the objective of achieving a satisfactory balance of payments outcome.

The staff had welcomed the policy of avoiding any increase in net official indebtedness abroad, Mr. Ismael said. At the same time, he noted that private capital inflows had assumed a dominant role in financing the current account deficit. As a result of heavy reliance on external capital, total external debt was estimated at 62.5 percent of GDP, and the debt service ratio was estimated at over 22 percent for 1985/86. The debt service ratio was expected to rise further unless foreign borrowing could be contained; it was therefore important to improve the current account position through firm financial policies, wage moderation, and appropriate external policies.

With respect to trade policy, the pace of implementation of the authorities' plan to reduce tariffs and other restrictive controls on imports had slowed down because of the large wage increases and the appreciation of the exchange rate, Mr. Ismael remarked. The objective of opening the economy to foreign competition was not likely to be achieved in the near future. He asked the staff to comment on how recent wage and exchange rate developments were likely to affect the attainment of the authorities' objective of import liberalization.

Mr. Leonard commented that the revised economic strategy initiated by the New Zealand authorities in the second half of 1984 was currently going through a testing time. Both the speed and path of adjustment were uncertain, entrenched attitudes were proving hard to overcome, and the ultimate success of present policies was more a matter of conviction than of demonstrable proof. Indeed, the general principle that seemed to emerge from the New Zealand experience was that the chances of the strategy reaching its objectives greatly depended on the credibility of the Government and the conviction and persistence with which it implemented its policies.

The Government had inherited a legacy of public attitudes and institutional behavior patterns based on a history of erratic official intervention, Mr. Leonard continued. It had changed the economic policy regime and must demonstrate in a clear, conclusive, and continuing way that it had done so. Otherwise, the benefits of supportive private actions and expectations that were essential for the strategy to have effect would be lacking, and the Government's aims were likely to go unrealized. It was encouraging, therefore, that the New Zealand authorities had recognized the need to establish the credibility and permanence of its policy approach and had implemented a bold and generally consistent package of policy measures.

The progress in reducing the structural deficit in 1985/86 was impressive, as was the authorities' commitment to full funding of the public sector borrowing requirement, Mr. Leonard said. Some slippage in meeting the budgetary target had occurred, and the fiscal outlook for 1986/87 was somewhat uncertain; however, measures had been taken to improve the quality and efficiency of government services and to reduce the budget deficit. Those measures had significant structural implications, and he wondered what the prospects were for reaching the desirable level of underlying deficit. He would also be interested in knowing the grounds on which an underlying deficit, as defined by the staff, was regarded as acceptable and, in particular, whether it was compatible with price stability.

There seemed to be a lack of definition in the Government's presentation of its position on fiscal policy that should be clarified, Mr. Leonard remarked. He could understand the authorities' reluctance to constrain their actions by adopting medium-term targets for the fiscal deficit. Perhaps a similar consideration underlay their stated position of not having any specific objectives for the overall tax burden or the size of the public sector. However, in view of the need for the Government's policies to carry conviction, a clear and comprehensive statement of the Government's fiscal intentions at the present juncture could increase the credibility--and therefore the probability of success--of the authorities' approach. He wondered how the Government could evolve a rational pay policy for the public sector and resolve the problem of special claims, especially for those at the higher administrative levels, without first clarifying its views on what the tasks, size, and structure of the sector should be and the consequent implications for the tax burden.

The introduction of the goods and services tax raised a similar question regarding the credibility of the overall strategy, Mr. Leonard continued. Although the tax was appropriate and even indispensable in New Zealand's circumstances, its timing and its effect on the cost of living index--adding about 5 percentage points--when the Government was committed to reducing inflation and there was a need for moderation in pay settlements, might raise questions as to the coherence of overall policies. He would welcome comments by Mr. Rye or the staff on the matter.

It was unfortunate, if inevitable, that deregulation of the financial sector had clouded the meaning and interpretation of monetary and credit indicators at a time when the information that they might have conveyed could have been most useful, Mr. Leonard observed. He did not suggest that the deregulation had been inappropriate, but he would like to hear from the staff and Mr. Rye how the New Zealand authorities would analyze the emerging relationships in the financial area. As other members of the Fund had learned from experience, such efforts were important in determining the conduct of monetary policy in a deregulated environment. The authorities should use a broad range of indicators to assess monetary conditions and they should provide market participants with as much information as possible concerning official objectives and operations.

Nevertheless, despite the high growth rate of monetary aggregates, monetary policy appeared to have been suitably firm, judging by the level of interest rates and the initial strength of the exchange rate, Mr. Leonard commented. Continuation of a firm monetary stance appeared to be desirable for some time to come, and the authorities would be well advised to keep the whole array of related indicators under review; a slowing down in the rate of growth of the monetary aggregates could be vital in enhancing the credibility of monetary policy and reducing inflationary expectations.

He agreed with the officials' argument that under a regime where the exchange rate was market determined, the attention of the authorities was better focused on the fundamental determinants of competitiveness than on measures of that competitiveness, Mr. Leonard noted. At the same time, prudence suggested that it would be advisable to keep an eye on the movements of such indicators, especially those related to the real exchange rate.

He welcomed the attention being given to the forthcoming wage round, Mr. Leonard said. The outcome of the 1985/86 round had been disappointing, reflecting in part the inherited rigidities in the wage determination system and the authorities' failure to limit special pay increases for public sector employees. The macroeconomic context in which the next round was set must be made clear to the negotiators on both sides, especially the Government's determination that financial policies would stay on course whatever the outcome of the wage round. For its part, the Government would need to secure the necessary degree of moderation in its own pay settlements and not give the wrong signal to the private sector. Over the long term, it was crucial that steps be taken to remove structural rigidities in the labor market so that the wage determination process would more closely reflect general economic conditions and the situations faced by individual firms. In the absence of marked progress in controlling pay increases, the overall strategy of the Government, particularly the fight against inflation, could be seriously damaged. A permanent improvement in pay and price developments would also be valuable in securing the reduction in the current account deficit that had caused external debt to reach its present level of about 60 percent of GDP.

The continued removal of industrial assistance, subsidies, and import protection was desirable, despite possible short-run adverse effects, as exposing the economy to market forces would improve overall economic efficiency and the allocation of resources, Mr. Leonard concluded.

Mr. Bertuch-Samuels said that he welcomed the basic reorientation of economic policies aimed at transforming New Zealand's economy into a more competitive open and market-oriented economy. That task was not easy, and not surprisingly the authorities had encountered difficulties and would continue to do so. However, those difficulties must be seen as a reflection of the large internal and external imbalances of previous years and of the rigidities resulting from past interventionist policies, including extensive wage and price controls and a high degree of subsidization in the economy. To overcome those problems would require a determined effort over a number of years. The success of the authorities' strategy would therefore depend crucially on their ability to inspire sufficient credibility and confidence by maintaining the momentum of the stabilization policies and thereby ensure a sound macroeconomic environment in which the microeconomic reforms could have their full beneficial effect.

The authorities' progress during the previous two years in correcting the large fiscal imbalances--even if the budget deficit for 1985/86 turned out somewhat higher than targeted--was commendable, Mr. Bertuch-Samuels remarked. However, he was concerned that at 3.6 percent of GDP, the structural deficit remained large. Moreover, the fiscal outlook for 1986/87 was still uncertain, and the deficit/GDP ratio could rise in that year. He therefore welcomed the authorities' prompt action in taking a number of measures to achieve additional budgetary savings, following the recommendations of the special Cabinet Committee.

The proposed tax reform, which provided for a shift from direct to indirect taxation and a simplification of the system of indirect taxes, was welcome, Mr. Bertuch-Samuels continued. The scaling back of direct taxation should make an important contribution to the strengthening of incentives in the private sector. However, the tax reform did not appear to be designed to be revenue neutral--a fact that might render the task of fiscal consolidation more difficult; he asked the staff or Mr. Rye to comment.

With respect to monetary policy, the strong expansion of credit and monetary aggregates during the past year had largely reflected the structural reforms undertaken in the financial sector and did not indicate a too generous supply of liquidity to the economy, Mr. Bertuch-Samuels commented. In fact, other indicators--in particular, the high real interest rate level--pointed to a sufficiently tight monetary stance. While it could be argued that the high interest rates constituted a heavy burden on the domestic economy, they should be seen as a necessary instrument in the overall effort to break the still widespread inflationary expectations. Any reduction in interest rates would hinge crucially on the ability of the authorities to further reduce the public sector borrowing requirement.

The results of the 1985/86 wage round, as well as the expected wage increases for 1986/87, were expected to be about 25 percent for the public sector and 15 percent for the private sector, according to the New Zealand Institute of Economic Research, Mr. Bertuch-Samuels noted. Those developments were a major cause for concern and, as recognized by the authorities, would be inconsistent with economic strategy; they would seriously jeopardize the attainment of greater price stability and weaken New Zealand's competitiveness. The Government would therefore be well advised to leave no doubts about its intention to adhere to a tight monetary stance, thereby signaling to both sides of the wage bargaining table that excessive wage settlements would in the end only have a negative impact on employment. Perhaps such a display of determination would also serve as an incentive for the bargaining parties to take greater account of the general state of the economy as well as of particular industries' economic and financial circumstances. In that connection, the envisaged legislative changes to increase flexibility in the labor market and the first steps already taken in that direction were welcome.

Moreover, there appeared to be a need for greater wage differentiation between skilled and unskilled labor, Mr. Bertuch-Samuels added. To do so could help to reduce the shortage of qualified personnel by strengthening incentives to seek better qualifications as well as by slowing down the recently growing trend of skilled workers emigrating to neighboring Australia.

The targeted significant reduction of the current account deficit in the current fiscal year was welcome, Mr. Bertuch-Samuels said. Nonetheless, he agreed with the staff that further efforts were needed to improve New Zealand's external competitiveness if sufficient trade surpluses were to be generated to compensate for the high share of external interest payments in the country's balance of payments. Important in that respect was the need for realistic wage settlements and continued fiscal restraint to permit a decrease in interest rates and thereby to ease the pressures on the exchange rate.

While welcoming the authorities' efforts to diversify the country's export base by promoting exports from the forestry and fishing sector, there was additional scope for increasing industrial exports, which had contributed only 25 percent to New Zealand's total exports in 1984/85, Mr. Bertuch-Samuels remarked. In particular, the authorities should intensify their trade liberalization efforts because, despite recent progress in that area, the country's industries appeared to remain highly protected. However, he appreciated the authorities' concern over the increasing protectionist tendencies in some of New Zealand's trading partners, and he agreed that efforts to roll back protection should be mutual.

Mr. Templeman noted that during the previous Article IV consultation discussion on New Zealand (EBM/85/93, 6/10/85), the Board had generally commended the New Zealand authorities for their bold approach to economic adjustment and structural reform. Impressive progress had been made in freeing up relative prices to help allocate resources more efficiently through the removal of price and wage controls; the floating of the exchange rate; and the removal or reduction of controls over interest rates, foreign exchange availabilities, credit allocation, and portfolio investments.

However, considerable work remained in strengthening macroeconomic management and in effecting structural reforms of markets and institutions in New Zealand, Mr. Templeman continued. Although good progress had been made in reducing the fiscal deficit, slowing the rate of growth of debt, restoring business profitability, and strengthening confidence in the private sector, substantial weaknesses remained. They concerned the rapid rate of expansion of the monetary aggregates, control over fiscal expenditures, and wage restraint. As a consequence, inflationary performance had been somewhat disappointing, the current account deficit of the balance of payments was still large, and--for an industrial country--the foreign debt burden was high.

To achieve durable real economic growth with a sustainable external position, New Zealand must close the inflation gap with its trading partners, Mr. Templeman stated. The 15 percent inflation rate in 1985/86 perhaps reflected the result of lifting price controls, devaluing the exchange rate, and increasing user charges, and the prospect of double-digit inflation again in 1986/87 might be partly the result of the introduction of the new goods and services tax later in 1986. However, the underlying rate of inflation still seemed too high to permit achievement of the objective of price increases that were no higher in New Zealand than the average of inflation in New Zealand's partners.

Two important explanatory factors were continued strong wage pressures and the accommodation of cost pressures by a high rate of growth of money and credit, Mr. Templeman said. Admittedly, the history of past government involvement in wage determination, several years of declining real wages, the recent recovery of profits, the catch-up in public sector salaries at the senior level, and labor shortages largely explained continued difficulties in keeping wage rate increases under control. The assumed 8 percent increase in wage rates in 1986/87 would be a notable achievement, which, however, did not appear assured.

There was a trade-off between a continued rapid increase in nominal wage rates and prospects for growth and employment, Mr. Templeman observed. National income data did not seem to be well developed in New Zealand, but available information on private investment over the past three years was encouraging. Employment growth had risen while the unemployment rate had fallen, but prospects for 1986/87 did not look so promising. In the short run, wage restraint in the next round of negotiations would be important in containing inflation, achieving real growth, and maintaining New Zealand's external competitive position. Over the longer run, a reduction in labor market rigidities would be at least as important. He looked forward with interest to the response of business and labor to the Government's discussion paper on labor reforms and to the presentation of labor legislation before the end of 1986.

Monetary aggregates had grown rapidly in recent years, with a rise of net domestic credit of 12-15 percent in 1983/84 and 1984/85, Mr. Templeman remarked. While there seemed to have been some deceleration of money and credit growth early in 1986, the growth rate still seemed uncomfortably high. Also, while he understood the difficulties of formal monetary targeting in the context of financial market deregulation, the preparation by the authorities of "conditional projections" of nominal GDP growth should provide a useful clue to the authorities' view of an appropriate rate of money growth. The implicit GDP deflators for 1985/86 and 1986/87 that could be derived from those projections would be about 11 percent or more, which did not seem consistent with the Government's inflation objectives.

He welcomed the full-funding approach to financing the fiscal deficit through securities issued at market rates of interest, as it introduced transparency into the cost of financing fiscal deficits and helped to generate a market-determined interest rate for resource allocation purposes, Mr. Templeman said. Unfortunately, the budget deficit target of 2.8 percent of GDP in 1985/86 had not been reached, although the deficit had fallen substantially, to 4.1 percent. However, all of the reduction had been due to revenue increases, while the expenditure ratio had actually increased over the previous year. For 1986/87, the staff report suggested that the deficit could rise again, but Supplement 1 to the staff report indicated that new fiscal measures would reduce the deficit by about 1 3/4 percent of GDP. Nonetheless, the position of the budget deficit ratio in 1986/87 remained unclear.

The steps taken to date in the area of tax reform, and the planned introduction of the goods and services tax in October 1986 to help reduce marginal personal income tax rates and to simplify the system of indirect taxes were commendable, Mr. Templeman commented. However, the top marginal tax rate for personal income tax of 48 percent and the increase in the company income tax rate from 45 percent to 48 percent raised questions about their effects on household and business incentives to save, work, and invest. Completion of the review of budget expenditures and tax expenditures described in Supplement 1 to the staff report and related fiscal measures would focus attention on the expenditure side of the fiscal accounts in helping to reduce the 1986/87 deficit. He also welcomed changes in the structure and financing of the state-owned trading enterprises, including planned legislation to permit the new bodies to operate fully on a commercial basis.

Real export growth, including diversification of exports, had been impressive, Mr. Templeman remarked. A substantial strengthening of New Zealand's international competitive position in 1981-84 seemed apparent from movements in relative unit labor costs and in the real effective exchange rate. However, there had been a reversal of trends in both measurements in the previous year or so, which was disturbing, especially in light of the planned withdrawal of government support for some economic sectors and planned trade liberalization. If trade liberalization were to proceed as expected, New Zealand's underlying competitive position needed to be relatively strong; it was therefore somewhat disappointing to learn of the scale-back in the anticipated reduction in customs duties.

The staff's medium-term balance of payments and foreign debt scenario was helpful, Mr. Templeman said. New Zealand had a high debt and debt service ratio for an industrial country, with a ratio of total debt to GDP of nearly 63 percent at the end of 1985/86 and a debt service ratio of more than 22 percent. A gradual reduction in foreign borrowing by the public sector should alleviate the official foreign debt burden, but a concurrent rise in private borrowing would, apparently, keep the debt burden high. For example, staff projections showed the total debt ratio falling only to 57 percent in 1991/92, while the debt service ratio would actually rise sharply to nearly 40 percent. He would have welcomed more information on private capital flows, for which no detailed statistics were shown for the period following 1982/83.

He did not underestimate the difficulties of economic adjustment, nor the political sensitivity of such matters as labor relations and tax reforms, Mr. Templeman stated. But if the authorities were to succeed in reaching their ambitious goals, simultaneous progress must be made in both the macroeconomic and structural areas. Only through firm determination by the Government, and with the cooperation of business and labor, could change be brought about in the inflationary expectations and ingrained habits that continued to overshadow the New Zealand economy. He was encouraged by Mr. Rye's statement that the Government remained strongly committed to maintaining the overall momentum of reform.

Mr. Schneider commented that during the previous Article IV consultation discussion on New Zealand (EBM/85/93), the Executive Board had commended the Government's newly adopted strategy based largely on market-oriented management and focused on medium-term objectives. In a small, high per capita income economy like that of New Zealand, it was courageous to aim at increasing market efficiency, removing controls on wages and interest rates, accelerating the process of trade liberalization, and letting the exchange rate float while pursuing tight monetary and fiscal policies. The main defects of that strategy mix stemmed from the reluctance or inability of economic agents and institutions to respond quickly to those changes and policy measures. Structural and behavioral rigidities, especially in the labor market, had proved to be major obstacles to progress, particularly with respect to inflation and the current account deficit. In addition, the economy suffered from other structural problems, especially the heavy tax burden and the size of the public sector. All those weaknesses had gradually slowed the economy to a standstill, and the real growth rate was expected to be negative for 1986/87. Against the present background of a favorable world economic outlook and the emphasis on growth issues worldwide, the diminished prospects for growth in New Zealand gave cause for concern.

He welcomed the authorities' awareness of the problems in the labor market--a vital but difficult area--and their intention to implement comprehensive reforms, Mr. Schneider noted. As the staff pointed out, regulatory reform was not likely to have much impact on the next wage round but would prove most helpful in the medium term, with respect to not only wage moderation but also better relations among the concerned parties. It would be unrealistic to expect moderate wage claims under the circumstances, and the situation called for tighter financial policies while monitoring exchange rate developments. In addition, the private sector's gains from lower world oil prices and interest rates would compensate for some increases in labor costs. If those gains occurred, the short-term outlook for the economy would be much better than expected; if not, the significant perils mentioned in the staff paper might well materialize.

One of the most critical elements in the attainment of a viable overall economic performance was fiscal policy, Mr. Schneider stated. Despite some progress in that area, the level of the budget deficit, the structural components of public expenditures, and the heavy tax burden remained worrisome. The staff had indicated at the time of the previous Article IV consultation discussion that, although no quantitative target for the medium term had been set out, the authorities had been aiming broadly at a deficit goal of about 2 percent of GDP. The papers under consideration made no specific reference to such a medium-term target; indeed, the staff indicated instead that, in the absence of policy changes, the deficit/GDP ratio might be expected to increase in 1986/87.

Short-term monetary management had been hampered by one effect of financial deregulation, which had been to obscure the impact of the behavior of the broader monetary aggregates on economic activity, Mr. Schneider noted. In addition, erratic seasonal swings in the public sector accounts and their reflection in the program of selling government paper posed an additional obstacle to monetary management. At risk were the consistency and credibility of monetary policy. However, according to the staff, interest and exchange rate behavior reflected a firm policy stance. In his view, the weakness of fiscal policy was one of the sources of upward pressure on interest rates, and he therefore believed that an improvement in the fiscal deficit and a reduction of the seasonal swings in the public sector accounts would go a long way toward obtaining lower market-determined interest rates and easing pressure on the exchange rate.

On the external side, Mr. Schneider continued, two issues predominated: the appreciation of the New Zealand dollar and the high level of external debt. The staff's illustrative medium-term debt scenarios showed that improvement of New Zealand's competitive position and the transfer of resources to the balance of payments were key objectives that should be pursued vigorously. The new floating exchange rate regime had cleared the way for the development strategy to follow a more market-oriented path. However, the staff also showed that some of the capital inflows associated with the rise in the exchange rate had flowed into heavily protected sectors, which had unhealthy implications for that market-oriented strategy. Therefore, the reduction of industrial protection and the withdrawal of external assistance were needed corrections, and the steps taken by the Government in those areas were most welcome.

The ambitious economic strategy pursued by the New Zealand authorities was encouraging and should produce sustainable growth in a viable economic situation in the medium term, Mr. Schneider observed. It was nonetheless clear that the existing structural weaknesses posed serious obstacles to implementation of the envisaged program. He hoped that those difficulties would yield to consistent and persistent efforts on the part of the authorities.

Mr. Fox remarked that the New Zealand authorities had made impressive progress in implementing the sweeping package of economic and structural reforms, that had received the overwhelming support and commendation of the Board one year previously. Unfortunately, as the authorities realized, the benefits of their strategy would be felt mainly in the longer term. The staff report provided a useful analysis of the many problems that remained to be tackled; in view of those problems, the authorities' determination to continue their strategy was all the more commendable.

Foremost among the problems the Government must face was the failure of wages to respond to the realities of the new economic environment, Mr. Fox noted. Admittedly, there had been a number of special factors at work during the previous wage round, and lower settlements could perhaps be expected in 1986 as activity slowed; he would be interested in any updated information from the staff. However, the experience of the previous year demonstrated the difficulty of changing the attitudes of wage negotiators, especially after a long history of direct government intervention. Nevertheless, the authorities had some scope for influencing the outcome of the current wage round without resorting to direct intervention, which should be avoided if credibility in the overall strategy was to be preserved. The authorities should lose no opportunity to explain their new approach and to spell out the trade-off between higher wages and employment. That was one of the benefits of a quantified medium-term financial plan, and he noted that conditional forecasts of nominal GDP had been used to that end. Setting a target for an intermediate monetary aggregate--such as M3--was difficult, given the pace of financial innovation and deregulation. But there was more scope for the authorities to publicize their medium-term financial objectives--for example, for the public sector borrowing requirement. He agreed with Mr. Leonard's comments on the need to stick with the chosen strategy so as to enhance credibility and change attitudes.

The Government could have an important influence on wage developments through its role as employer, spelling out the implications for public sector wage rises of their financial objectives and enforcing market disciplines in state enterprises, Mr. Fox observed. The review of state pay fixing should prove useful in that context.

He commended the authorities for ensuring that the new goods and services tax would be introduced in a way that minimized its impact on inflationary expectations, Mr. Fox said. That meant not only getting the timing right but also emphasizing that the effect on prices would be offset by the increase in disposable income from the associated cuts in income tax and that the once-off rise in prices would therefore not be accommodated by faster monetary growth that would only exacerbate inflation.

The continued high rate of monetary growth despite high real interest rates and the full funding of the public sector borrowing requirement had been worrisome, Mr. Fox commented. An important factor had been financial deregulation and innovation; another had been the scale of external inflows, until the end of the previous year, reflecting improved confidence in the New Zealand economy. The fact that rapid monetary growth had been accompanied by high real interest rates and an appreciating exchange rate suggested that monetary policy had not been too lax. He welcomed the authorities' intention to continue fully funding the public sector borrowing requirement. However, Table 20 in the report on recent economic developments indicated that whereas the Government's contribution to monetary growth up to March 1985 had been negative, it had been increasingly positive subsequently; he asked the staff to comment.

The continued high level of real interest rates and the slippages in fiscal policy emphasized the need for intensified efforts on the fiscal front, and he welcomed the further measures that had been taken, Mr. Fox remarked. However, he would like to know what those measures implied for the ratio of the central government deficit to GDP in 1986/87, and, in view of the switching of some spending and borrowing to off-budget categories, the effect on the overall public sector borrowing requirement. He urged the authorities to make their medium-term goals for the public sector borrowing requirement more explicit.

A further reduction in government borrowing should also help to reduce pressure on the exchange rate, Mr. Fox added. To a large extent, the appreciation over the previous year reflected improved confidence; moreover, despite the nominal appreciation, the exchange rate remained significantly below the immediate predevaluation level, although less so in real terms given the rapid increase in wages. The authorities were therefore right not to ease monetary policy in response to exchange rate developments, especially in view of the need to help maintain downward pressure on inflation. As the authorities recognized, a high exchange rate might well be an inevitable consequence in the early stage of disinflationary policies. The volatility of the exchange rate over the previous year was perhaps not surprising, given the limited history with free floating in New Zealand. He would be interested in the staff comments on the desirability of perhaps more stability or whether it considered that an entirely free float was appropriate in a small, mainly agricultural economy.

The authorities had set themselves an ambitious task, and they remained largely on course, Mr. Fox concluded. Unfortunately, the legacy of a long history of intervention presented a number of long-entrenched distortions that hampered macroeconomic success and that could be removed only after a prolonged period of structural reform.

Mr. Sugita noted that despite difficulties and unexpected developments in some areas, the authorities had pursued with determination an economic stabilization program that, in a clear departure from past policies of controls and intervention, had placed strong emphasis on market forces. In 1985, reform measures had been continued and implemented in a number of areas; an inefficient export promotion scheme had been terminated and the pricing of public sector services had been changed to a full cost-recovery basis. Further steps had been taken to liberalize financial markets and import licensing requirements. A major reform of the tax system had been announced. Reinforcing structural reform, fiscal and monetary conditions had been kept generally tight, with the fiscal deficit having declined to 4 percent of GNP in 1985/86 from 6.8 percent the previous fiscal year. However, the performance of prices and the balance of payments had not lived up to expectations, and there had been a serious setback on the wage front.

A sharp increase in wages had come at a particularly inopportune time, when economic activity had been about to slow down, Mr. Sugita observed. High interest rates and a profit squeeze induced by the wage increase were likely to dampen business investment for some time, thereby prolonging the period of economic downturn and adjustment. In spite of that setback, the authorities were determined to proceed with structural reform--with particular emphasis on labor markets--and to maintain fiscal austerity and tight monetary conditions; they were to be commended for their strong commitment to the pursuit of that stabilization policy.

With respect to fiscal policy, expenditures had risen moderately relative to GDP in 1985/86, compared with a sharp fall in 1984/85, Mr. Sugita remarked. While that development might not necessarily imply the loosening of efforts directed toward budget restraint, additional expenditure control was needed for a sustainable reduction of the budget deficit. On the revenue side, the introduction of a goods and services tax in October 1986 would be a major milestone in the overhaul of the tax system. While that reform was highly desirable, its implications on price developments required some caution. To avoid a rekindling of inflationary expectations arising from the tax increase, monetary conditions had to be kept tight. However, maintenance of excessively high interest rates involved the risk of exchange rate appreciation, which would be harmful to balance of payments adjustment. Although those two conflicting considerations posed a difficult balancing task for the authorities, it was most important to avoid excessive oscillations in monetary conditions, that could give rise to an unnecessary swing in expectations. Therefore, the authorities were well advised to place emphasis on the consistency with which they conducted monetary policy.

The staff's tentative balance of payments projection indicated stabilization of the current account deficit at about 2.5 percent of GDP, Mr. Sugita noted. Nevertheless, the recent weakness in the prices of main export items--including dairy products, meat, and wool--was a source of some concern. The prospect was further complicated by a sharp depreciation of the currencies of the United States and Australia, two major exporters of farm and dairy products. Under such circumstances, structural change became all the more important for sustained improvement in the current account balance. He welcomed the measures taken by the Government in December 1985 to improve the scope for diversification and investment in the farm sector and, in particular, the introduction of legislation that would allow persons overseas to purchase or lease farmland. It would also be desirable to accelerate the pace of reducing the high tariffs for a more efficient allocation of domestic resources.

Mr. Polak said that the authorities should be congratulated for the long list of measures they had implemented: reforms in financial policies, the phasing out of subsidies and selective assistance, deregulation of the financial market, import liberalization and removal of export incentive schemes, the lifting of price and wage controls, and a major reform of the tax system. Such a comprehensive array of structural and financial measures was rarely seen in any adjustment program. In addition, fiscal policy had reduced the budget deficit from 8.9 percent to 4 percent of GDP, monetary policy had been tight, and a flexible exchange rate policy had been pursued. Against that impressive background of measures, the results were not as positive as might have been expected. GDP growth had slowed to a crawl, unemployment was slightly higher, and inflation--although down--was still at about 10 percent. Those results were attributable in part to highly unfavorable external circumstances and perhaps to overambitious deregulation and they were probably due to the time lag necessary for the measures to work through the economy. The authorities must stay the course--after so many years of interventionist policies--in the firm expectation of greater policy dividends in the near future.

Most difficult to understand was the persistence of high real interest rates, which had been partly responsible for the run-up in the real exchange rate for the New Zealand dollar in the second half of 1985, although that movement had been partly reversed subsequently, Mr. Polak remarked. Those high interest rates presumably were a lagging effect of the tight adjustment policy that had not yet dislodged earlier inflationary expectations. The staff supplement seemed to confirm that view, indicating that interest rates were tumbling sharply in the second quarter of 1986. Interest rates had been needlessly variable from month to month, reflecting short-run changes in the Government's borrowing requirement; it should be possible to mitigate those effects through technical measures affecting tax payments or through liquidity management.

The exchange rate had also been highly variable, Mr. Polak continued. After the 20 percent depreciation in 1984, the currency had appreciated in the second half of 1985 to a real level higher than the predevaluation rate. The authorities had aimed for a float "as clean as possible," which might have been necessary in the early stages of the program, when it had been important to demonstrate to the market the change in approach. Moreover, the recent decline in interest rates might help to move the exchange rate back to the proper level from the point of view of competitiveness. In any event, somewhat greater preparedness to intervene in order to reach the "proper rate"--on which the authorities should have a view--seemed appropriate. Pressure on the exchange rate was an inevitable consequence of the disinflation process, and the authorities should stick to that process until interest rates were forced down by market forces. In the absence of a fully competitive rate, more deflationary domestic measures would be needed to achieve the desired balance of payments improvement, and farm income would be even more depressed. The exchange rate could also be helpful in fostering the switch to nonpastoral exports, which had already made considerable progress, and in facilitating the much needed liberalization of imports.

The result of the 1985 wage round, while disappointing, was not as serious as portrayed by the staff, Mr. Polak stated. Wage policy remained the most important area in which the authorities still had to initiate reforms. However, he would not attribute the result of the wage round to the ability of trade union power to distort economic relationships. In fact, the distribution between wage income and profits, which had been nearly stable for a decade, had been pulled strongly in the direction of profits in 1984/85, and a correction was natural, certainly in a period of high demand for labor. The large profits, together with the Government's policies on imports and overall demand, also served to limit the impact on prices of the large wage settlement.

Mr. Ebrill commented that the New Zealand authorities had made significant progress toward their goal of increasing the efficiency and flexibility of their economy. Many of the measures taken had been far-reaching and courageous. He commended the authorities for their efforts; in particular, he welcomed their decision to adopt a comprehensive, rather than piecemeal, approach to reform.

Great progress had been made in restructuring taxes, notably the recent comprehensive tax reform package, Mr. Ebrill said. The reduction in marginal tax rates on personal income and the intention effectively to integrate personal and corporate taxes were commendable. He welcomed the increased emphasis being placed on indirect taxation through the introduction of the goods and services tax and the intention to minimize its once-off effects on inflationary expectations. On balance, the tax reform package should contribute to enhanced efficiency while broadening the tax base.

There had been less progress on the fiscal expenditure side, however, Mr. Ebrill remarked. Total expenditure in 1985/86, at 39 percent of GDP, stood close to its all-time high. Reducing expenditure was important not only from the short-term perspective of further reducing the fiscal deficit but also from the longer-term perspective of containing the size of government. The authorities had completed a comprehensive review of some categories of expenditure, and he was encouraged that, as a result, savings equal to 1 3/4 percent of GDP were expected in 1986/87.

He welcomed the authorities' intention to subject public sector enterprises to market discipline, but he noted that they did not intend to privatize any public sector entities, Mr. Ebrill said. That raised the question of whether the extension of market discipline to the state enterprise sector included the possibility of closing individual enterprises that were not too viable. He welcomed the intention of the authorities to proceed with the restructuring of major projects initiated in recent years; he wondered if there were any forecasts of the cost associated with that effort. With respect to government expenditure, the authorities were setting up a Royal Commission to review social policy. Given the relatively rapid increase in the share of social service expenditure in total government expenditure, that was a welcome development.

On monetary policy, the extensive deregulation of the financial sector was clearly one of the most notable achievements of the current administration, Mr. Ebrill continued. The resultant rapid structural change in the sector created uncertainty concerning the stance of monetary policy. In fact, the growth rates of some of the monetary aggregates had been volatile and relatively high. However, the authorities had taken steps to enhance their control of liquidity management, which should help to mitigate volatility. Furthermore, both the authorities' commitment to finance the public sector borrowing requirement by issuing securities and the behavior of some variables--such as the initial strength of the exchange rate--all suggested that monetary policy would continue to be consistent with the authorities' commitment to nonaccommodating macroeconomic policies.

As the authorities were well aware, the recent wage round had demonstrated a lack of flexibility in determining wage relativities, Mr. Ebrill observed. He therefore welcomed the fact that the authorities were encouraging a debate on industrial relations. Furthermore, the emphasis on "composite" bargaining at the individual industry level was promising. On the occasion of the next wage round it was important to encourage not only wage flexibility but also wage moderation. The recent large increases might well have been inevitable, given the preceding wage freeze; however, a further large wage increase could compromise New Zealand's anti-inflation policy and external competitiveness.

On supply-side policy, he commended the authorities for the numerous measures they had implemented to improve resource allocation, Mr. Ebrill remarked; in particular, government subsidies to the agricultural sector had been withdrawn. However, more remained to be done. In particular, the authorities should seek further reductions in tariffs in manufacturing. It was also important that its traditional trading partners recognize New Zealand's advantage in areas such as agriculture by granting the country access to their markets, especially if New Zealand's economic policy was not to be greatly complicated.

The authorities were to be commended for the decisive and comprehensive fashion with which they had tackled their problems, Mr. Ebrill said. In particular, the manner in which they had sought a balance between macroeconomic and microeconomic measures to attain their goals was praiseworthy. By emphasizing a shift to a more market-oriented economy, the authorities were in the process of laying the basis for sustained growth.

Mr. Vasudevan remarked that the economic performance of New Zealand during 1985/86 had been somewhat mixed and uneven. The authorities had been tested with the question of whether the economic strategy pursued since July 1984 should be continued or left in midstream, but the authorities had rightly decided to proceed with the current strategy since imbalances still existed in the economy. The results of the adjustment strategy would probably take time to become fully apparent; in addition, given the limited experience with liberalization and deregulation, the speed and nature of the responses of economic units to adjustment policies would be hard to predict. The absence of definitive information about the stability of the behavioral relations posed serious difficulties in tackling the issues of inflation and exchange rate appreciation. He did not suggest that the strategy pursued thus far should be given up, or that there should be emphasis on stabilization policies versus reforms. He was in general agreement with the authorities that achievement of stabilization goals would be costly in the absence of structural reforms.

Reforms were important in the bargaining system; undoubtedly, nominal wages had increased in 1985 at a faster rate than in 1984, and the wage settlement effected in 1985/86 had provided for payments that were close to the recorded rate of inflation, Mr. Vasudevan noted. But as Table 9 of the report on recent economic developments illustrated, real wages in general had declined by a higher percentage in 1985 than in 1984. In addition, the profit margins in manufacturing, as shown in Chart 7 of that report, had risen in 1985. In such a situation, it could be expected that unions would bargain for pay increases. However, he hoped that satisfactory understandings would be reached in the wage negotiations. The authorities should be commended for taking an open-ended position on the institutional reforms of the labor market by letting a debate take place on industrial relations. Nevertheless, it was not clear how great an impact wage restraint would have on domestic demand and thus on income generation. Some clarification in that regard would be appreciated.

The fiscal performance in the previous two fiscal years had been generally good, Mr. Vasudevan commented. Not only had there been a reduction in the deficit from 8.9 percent of GDP in 1983/84 to 4 percent in 1985/86 but a number of actions had been taken to improve resource allocation and to reform taxation. In addition, the authorities--in an effort to keep the deficit within limits--had recently set up a Cabinet Committee to review and appraise all expenditure programs. It appeared from Table 17 of the report on recent economic developments that the fiscal effect of the tax measures in 1986/87 would be substantial. If expenditure appraisals led to cuts in spending, there would be a reduction in the fiscal deficit to the envisaged extent. Information in the staff report on the size of the deficit in 1986/87 was not clear, but the staff stated that there should be a further reduction in the fiscal deficit from 4 percent of GDP in 1985/86; he supported that position. However, it might be asked how far the deficit should be reduced in light of the expected decline in real income of about 1.5 percent in 1986/87.

The critical area of policymaking had been monetary policy, where financial deregulation and innovations had been substantial, Mr. Vasudevan remarked. In view of the uncertainty about the stability of the demand for money and other behavioral relationships, the authorities had little choice but to constantly observe the various economic indicators--notably the interest and exchange rates--to assess monetary conditions. Money supply growth had so far been rapid. With prices at high levels, the authorities had tended to follow firm monetary policy. Reduced access to the private sector for central bank credit was an important method by which "primary liquidity" had been kept within limits. While the authorities' commitment to fully funding the public sector borrowing requirement had helped to advance the credibility of monetary policy, it had also led to firmness in interest rates. The policy had had the effect of reducing the ability of financial institutions to expand credit, but it had not necessarily led to a corresponding reduction in the potential spending power of the private sector. Liquidity management had become complex and had not succeeded in reducing short-term variations in interest rates.

The need to reduce the public sector borrowing requirement could not be overemphasized in the context of the necessity of curtailing the spending power of the private sector, Mr. Vasudevan continued. But there was an equally important obligation to deal with the paradox of high liquidity and high interest rates to bring down the inflation rate and at the same time ensure an adequate amount of investment and inventory demand. In view of the uncertain behavioral relationships, it was difficult to determine the appropriate conduct of monetary policy, but a firm stance would probably be perceived as credible in the circumstances. In that sense, he could go along with the staff appraisal, but he wondered whether there could not be other subtler measures of monetary policy to deal with the situation.

He was in general agreement with the assessments of the external sector by the authorities and the staff, Mr. Vasudevan said. He especially commended New Zealand's official development assistance and the authorities' commitment to the target of 0.7 percent of GNP, as well as recent attempts to adopt a relaxed Generalized System of Preferences for imports from developing countries.

Mr. Archibong commented that the economy of New Zealand had experienced relative weakness in 1985/86, with gross domestic output estimated to have risen by barely 1 percent as against 5 percent in 1984/85. Growth prospects for 1986/87 were no better as official forecasts indicated that real output would fall by about 1.6 percent. Much of the recovery in economic activity that characterized the previous two years had taken place under an expansionary stance of financial policies and strong growth in the volume of exports, backed by buoyant demand in trading partner countries. Such favorable circumstances had since yielded to serious weaknesses in commodity prices and a significant fall in agricultural output under conditions of a large withdrawal of fiscal stimulus and a nonaccommodating monetary policy.

Nevertheless, given the growing inflationary expectations and the surge in wage earnings, the authorities should persevere in their tight monetary and fiscal posture, Mr. Archibong continued. Thus far, the monetary policy stance remained firm, as indicated by the behavior of interest rates and the exchange rate and the slowdown in credit expansion. The commitment on the part of the authorities to fully fund the public sector borrowing requirement was encouraging. But it was necessary to make progress in lowering government borrowing needs; otherwise, the private sector, which bought most of the government debt instruments, would bear a disproportionate cost of the burden of adjustment. The authorities must also monitor the impact of monetary policy measures in order to ensure that real output and employment costs of the adjustment process were kept within economically tolerable limits.

The authorities had recorded some success on the fiscal front, Mr. Archibong noted. The fiscal deficit had been reduced, and the authorities were committed to a further reduction over the medium term. Although the deficit, currently at about 4 percent of gross domestic product, might still be high, the measures already in place to contain spending appeared to be appropriate. Noteworthy were the phasing out of agricultural subsidies, the gradual raising of charges on goods and services provided by the public sector to levels sufficient to cover costs, and the introduction of measures to improve the efficiency of state-owned enterprises and to broaden the tax base. The authorities should not, in the existing circumstances, resort to tax increases to further reduce fiscal disequilibrium. Such an action could undermine the prospective benefits of the pending far-reaching reform of the tax system. Rather, the ongoing review of public expenditure policies should provide an excellent opportunity to critically assess public expenditure priorities with a view to substantially reducing government spending through expenditure cuts. Such fiscal adjustment would ease upward pressure on interest rates and the exchange rate of the New Zealand dollar.

Labor market rigidities constituted a formidable problem that must be tackled effectively, Mr. Archibong stated. Not least was the problem of wage determination, which failed to bear an appropriate relationship to economic realities. If labor continued to show a lack of moderation in its demands, as was the case at present, the authorities should seek to promote an understanding with unions and employers in the interest of wage moderation in the economy. The need for regulatory reform was most pressing in the labor market. In that connection, the ongoing debate initiated by the authorities on the industrial relations framework was welcome; he hoped that it would help clarify labor issues and pave the way for labor market reform that could provide the much needed conditions conducive to pay restraint.

The New Zealand authorities were to be commended for their commitment to deregulation, reliance on market forces, and a liberal trade policy, Mr. Archibong remarked. The shift of policy emphasis from a preoccupation with the management of aggregate demand to deregulation reflected the authorities' belief in the removal of distortions of market signals resulting in an efficient allocation of resources. The acceleration in the process of trade liberalization was being pursued in many ways, including the phasing out of various export incentive schemes and the dismantling of the import licensing system for certain sectors of the economy. However, for New Zealand to fully reap the benefit of its trade liberalization measures, its trading partners must reciprocate with an equally open trading policy, free from protectionism.

New Zealand's continued adherence to the UN target of 0.7 percent of GNP for official development assistance was commendable, Mr. Archibong commented. He welcomed the authorities' plan to raise their assistance from 0.22 percent in 1984/85 to 0.51 percent of GNP by 1991. He hoped that the current review by the authorities of the Generalized System of Preferences would lead to greater assistance to developing countries in the form of a generally lower level of tariffs.

The staff representative from the European Department said that the package of fiscal measures announced in May 1986 had improved the prospects for the budgetary accounts for 1986/87. However, a number of other factors, including cyclical factors, tended to raise the deficit. Therefore, in the absence of additional measures, it was likely that the budget deficit in 1986/87 would increase, probably to about 4 1/2-5 percent of GDP. Some of the measures that had been taken in May 1986 to reduce public expenditure programs would not result in equivalent savings in the real resources absorbed by the public sector. While they would lower the deficit, they would not reduce pressures in the financial market. The authorities did not have a firm target for the size of the budget deficit over the medium term, but in broad terms they accepted the notion that the underlying deficit should not exceed the amount required to finance net additions to the stock of real and financial assets owned by the public sector. Such a target would not necessarily be incompatible with progress toward price stability, although it could be argued that a more ambitious target would be desirable to enhance the economy's growth potential.

In March 1985 the authorities had published medium-term fiscal scenarios that envisaged a reduction in the deficit to about 3 1/2 percent of GDP by 1987/88, the staff representative continued. The scenarios, which were intended to encourage public debate on the state of the public finances, had been based on a number of assumptions about the macroeconomic outlook and on policies that had already been in place. The outlook had worsened since that time, but revised medium-term financial scenarios had not been published pending the outcome of the public expenditure review.

The introduction of the goods and services tax was necessary in order to allow the authorities to reduce the high rates of personal income tax, the staff representative remarked. While the top marginal income tax rate of 48 percent resulting from the reform could still be considered high, the scope for further reduction at present was limited given the need to lower the budget deficit. Initially, the authorities had intended to introduce a tax reform package that would be revenue neutral. However, revenue neutrality would have required a rate of the goods and services tax in excess of 10 percent which, it was feared, would have created problems of tax compliance. In the event, the package that was introduced entailed a cost to the budget of $NZ 750 million in a full year, but part of that cost would be offset by fiscal drag estimated at $NZ 400 million in 1986/87.

It could be argued that, because of the large increase in wages that had taken place in the latest round and the worsening of the fiscal outlook, the introduction of income tax reductions should probably be delayed, the staff representative said. However, a delay could undermine the credibility of the authorities' strategy. The authorities had rejected that option, but the measures that they had taken recently to raise charges for goods and services provided by the public sector, together with the effects of fiscal drag, would tend to moderate the growth in real personal disposable incomes.

The authorities were concerned about the potential inflationary implications of the introduction of the goods and services tax (GST), but they hoped that the wage earners would accept that income tax reductions provided sufficient compensation for the price effects of the GST, the staff representative stated. It was important to maintain firm financial policies to minimize any inflationary effects.

As in other countries where the pace of deregulation had been rapid, it had become difficult to assess monetary conditions and the stance of monetary policy in New Zealand, the staff representative commented. Since monetary aggregates were clearly influenced by the reintermediation of financial flows, the staff had attached more weight to the behavior of interest rates and the exchange rate, which suggested that monetary conditions had been tight during 1985 and early 1986. Recently, the rate of monetary growth had also slowed, on a quarter over quarter basis, tending to confirm the judgment that monetary policy had been exerting a restraining influence on inflation and demand. However, the growth of monetary aggregates was still high, and there was some way to go before monetary developments could be viewed as being fully compatible with the authorities' medium-term objective of achieving a low and stable rate of inflation.

The recent pronounced fall in interest rates was due in part to the decline in international interest rates and the weakening of economic activity in New Zealand, which had dampened the demand for credit, the staff representative explained. However, the fact that long-term rates had also fallen sharply suggested that confidence factors had also played an important role. In particular, inflationary expectations appeared to have abated following the publication of the March figure for the consumer price index, which had been significantly lower than expected. Also, the outturn for the budget deficit in 1985/86 had been lower than the market had expected, which had contributed to strengthened confidence. Although the package of expenditure cuts introduced in May had been generally well received, it was unlikely to have been a major factor; most of the decline in interest rates had taken place before the announcement of the package.

There had been no significant change in the basic thrust of monetary policy, the staff representative stated. The authorities continued to aim at funding the budget deficit through sales of government securities in the domestic market. However, short-term liquidity management policy could not always achieve its objective of maintaining primary liquidity at a constant level, as it was difficult to forecast with precision all the factors that impinged on liquidity conditions. A small unintended increase in primary liquidity appeared to have occurred in May, contributing to the fall in interest rates, but the authorities had taken corrective action in June by stepping up their operations in the money market.

The high rate of growth of credit to the Government in the year to December 1985 had been largely an aberration, the staff representative noted. Figures for the year to March 1986 showed that the rate of growth of credit to the Government had slowed down sharply to about 15 percent. The increase in the year to December 1985 had been associated in part with exceptionally large capital inflows in the December quarter of 1984, which had helped to finance a large part of the budget deficit, thus obviating the need for the Government to borrow domestically. By contrast, foreign financing of the deficit in the December quarter of 1985 had not been significant.

The staff shared the concerns expressed by many Directors about the outcome of the 1985/86 wage round, the staff representative said. The latest figures suggested that the increases for the private sector were about 16 1/2 percent, slightly more than indicated in the report; increases amounted to 25 percent for the public sector. Under present arrangements for the determination of wages, a tripartite wage conference took place before the beginning of each round, and the 1986 conference was currently under way. The Government had stressed that it did not view the conference as the appropriate place to begin negotiations for 1986/87 but regarded it only as a forum for disseminating information on the state of the economy and its policy intentions. The authorities had emphasized the point that large increases in wages would have adverse effects on employment and output growth. Employers had submitted a paper to the conference calling for a wage pause until the industrial framework was reformed. However, that suggestion had been rejected by the unions and by the Government, which had stated that the reform could not be implemented fast enough to make that idea practical. The official macroeconomic forecasts were based on the assumption that the average increase in wages in the next wage round would be about 8 percent. Private forecasters predicted somewhat higher numbers. The main factor of uncertainty lay with the introduction of the goods and services tax and in particular whether the unions would agree not to ask for compensation for the price effects of that tax.

The current account of the balance of payments was likely to improve markedly in 1986/87 and 1987/88, the staff representative commented. He expected the deficit for 1986/87 to be somewhat lower than the 3 1/2 percent of GDP indicated in the staff report because the effects of the decline in oil prices had not been reflected in the forecast and because the effect of the temporary factors that had tended to raise the deficit in the last quarter of 1985/86 would be reversed in 1986/87. Furthermore, given the present and prospective weakness of commodity prices, a significant amount of disinvestment in the farm sector would take place, thereby boosting agricultural exports in the short run.

For the medium term, an improvement in competitiveness would be necessary to reduce the current account deficit, the staff representative said. The authorities would welcome a decline in the real exchange rate but they did not believe that official intervention in the foreign exchange market could help achieve a permanent improvement in the competitiveness, as such intervention would undermine the objectives of monetary policy. The restoration of competitiveness could be achieved only gradually, through the maintenance of firm financial policies, further progress in reducing the structural component of the budget deficit, and reform of the labor markets to reduce pressures on wages and wage costs.

The high level of wage increases in the recent past and the weakness of competitiveness had not deterred the authorities from their pursuit of trade liberalization, the staff representative stated. While the practical difficulties constraining liberalization should not be underestimated, it was encouraging that various sectors that were adversely affected by the maintenance of restrictions were urging the authorities to speed up the pace of liberalization, and it was likely that further progress would be made gradually.

Detailed historical data on capital movements were not available beyond 1982/83, the staff representative from the European Department said. However, the overseas exchange transactions data presented on page 75 of the report on recent economic developments gave some useful information on the composition of capital flows.

The staff representative from the Exchange and Trade Relations Department commented that exchange rate intervention per se would invite questions concerning monetary management under deregulation and the authorities' approach to sterilization or nonsterilization of such operations. There seemed to be a trade-off: on the one hand, intervention might allow the authorities to signal what they considered to be the appropriate exchange rate or to resist a deviation therefrom; on the other hand, particularly in the current environment of uncertainty over growth rates of monetary aggregates, there might be some question about the immediate intent of the authorities regarding monetary growth and monetary policy generally. Moreover, that action might call to question the longer-term intent of the authorities to remain committed to a completely free float--a measure that had been taken initially to convince the public of a new era in economic policymaking. It would be useful for the authorities to indicate more specifically their intent on financial targets over the medium term so as to establish public confidence in those targets before they attempted to change their policy on intervention.

Mr. Rye observed that the present was a testing time for New Zealand's economic strategy, exemplified by the confrontation between that medium-term strategy and the short-term problems that had arisen largely as a legacy of the past. Some of those problems, such as those arising from wages and from the previous Government's policy of massive development projects, had proved to be more intense than foreseen. Nonetheless, the Government would continue to pursue vigorously its longer-term strategy in the belief that any other course would destroy the credibility it was continuing to build up.

Because of the disappointing wages outcome the previous year, incomes policy had been suggested, but that would be a complete turnabout in the Government's position, Mr. Rye stated. The Government could not contemplate wages policy in its medium-term strategy, which was based on the need to make wage-fixing processes more in line with economic realities and more attuned to the different prospects facing different industries and to encourage flexibility between skilled and less skilled occupations. The Government saw its role as essentially ensuring that both employers and trade unions were fully aware of the economic problems facing New Zealand and of its determination to pursue a macroeconomic strategy that would not be accommodative to unsustainable wage and salary increases.

Speakers had criticized the large wage settlement in the public sector the previous year, Mr. Rye recalled. Undoubtedly, the Government had been slow to appreciate that, in some areas, a buildup of settlements was going beyond what was warranted. However, wages in other areas of the public sector had fallen seriously out of line with the private sector, and major adjustments had been necessary--not only in particular occupations but across the board at senior levels. It was not so much the size of the increases granted at those levels that had induced a stronger effort by the trade union movement as the revelations in the course of hearings that the wage freeze--which had been applied strongly to the trade union sector--had not been applied to the upper echelons of the private sector.

The budget that would be presented in late July 1986 would set out the deficit for 1986/87, Mr. Rye noted. The factors leading to an increased budget deficit in 1986/87 would outweigh the more favorable influences, including savings estimated to be $NZ 700 million greater in 1986/87 than in 1985/86. Other favorable influences included the recently announced expenditure measures, which in indicative terms were $NZ 800 million; fiscal drag; and lower interest rates, which should help debt-servicing costs. However, those factors would be offset by more adverse influences, including the effects of a much flatter economy; the losses associated with major projects, for which the Government was determined to cease subsidization; the net fiscal cost of restructuring the tax system, which could not be further deferred; and the rise in the expenditure base resulting from the 1985/86 public sector wage round. Therefore, progress toward the Government's medium-term objectives could be expected not in 1986/87 but in the years ahead.

Because of the previous Government's large involvement in the form of guarantees on markets and loans, the present Government was faced with assuming the financial responsibility for many large projects, Mr. Rye explained. The Government had had to agree to finance nearly $NZ 1.2 billion of debts incurred by New Zealand Steel Development. A refinery project amounting to $NZ 2.4 billion and other projects accounted for a total debt of $NZ 5.8 billion, which was very large in the context of the New Zealand economy. At present prices of oil and alternative fuels, those projects would make only a minimal contribution, if any, to interest costs or capital repayments. In effect, because of the commitments entered into by the previous Government, the taxpayer would have to take on the servicing of those loans.

One speaker had described the recent fiscal measures as cosmetic, Mr. Rye recalled. Actually, the Government had realized the strong need to improve efficiency in the state sector. Granted, a significant part of the fiscal savings from the "corporization" of state enterprises would take the form of financing pushed off budget. Nonetheless, efficiencies and savings would be realized by exposing those activities to market discipline. For example, the state enterprises would have to raise a good deal of their future financing on the market, thereby imposing self-discipline. They would also have to use retained earnings as a source of additional resources, and they would have to charge for services which in the past had been provided at the taxpayers' expense. Thus, the demand on services would be reduced, leading to expenditure savings.

With respect to trade policy, the program for reducing tariffs seemed less ambitious than envisaged, Mr. Rye remarked. The Government had taken the view that, given the long history of protectionism in New Zealand, it was essential to build a constituency for reform, and it was engaged in a close consultative process with the industries concerned. The approach that had finally been agreed upon involved somewhat slower progress than had been envisaged. But there was a quid pro quo in the form of a significantly faster phaseout of import licensing, which would, in effect, be removed for almost all items by 1988. There would be a major review at that time, with the possibility of accelerated progress thereafter.

The Chairman made the following summing up:

Executive Directors expressed their continued support for the ambitious economic strategy introduced in 1984 by the New Zealand authorities with a view to increasing efficiency and flexibility in the economy, lowering inflation, and fostering balanced growth in output and employment over time. Directors welcomed, in particular, the strong medium-term structural orientation of the strategy and its emphasis on achieving consistency and balance between the various strands of policy and on improving the functioning of market mechanisms.

While noting the impressive array of structural measures adopted by the authorities, the continued high level of activity and employment, and the progress made in strengthening the external position, Directors also observed that the transitional costs of the strategy had surfaced clearly and were being exacerbated by the surge in labor earnings in the 1985/86 wage round. Thus, Directors emphasized that while perseverance with the basic thrust of the strategy was essential, further adjustments in the present policy stance, particularly in the fiscal area, were necessary to dampen inflationary expectations and to alleviate upward pressures on interest rates and the exchange rate which, if sustained, could have detrimental effects on the tradables sector and undermine the success of the strategy.

Directors agreed with the New Zealand authorities that further adjustment in the labor market was a major task. While special factors had contributed to the high level of settlements in the recent past, Directors also considered that institutional features of the labor market impaired the attainment of wage restraint and flexibility. Many speakers underscored the importance of achieving a marked deceleration in the growth of wage costs in the period immediately ahead. To this end, Directors urged the authorities to adhere to firm financial policies and to make it absolutely clear that excessive wage and salary increases would put jobs in jeopardy and risk deepening and prolonging the recession. The present more subdued economic environment would, it was hoped, be helpful in fostering wage restraint.

Directors emphasized in particular that it was necessary for the authorities to ensure adequate restraint and flexibility in public sector pay awards, taking into account the fact that in 1985/86 increases in public wages and salaries had exceeded those in the private sector by a large margin. Speakers also welcomed the debate on the reform of the industrial relations framework, which the authorities had recently initiated, and they emphasized that the reform should aim at putting in place arrangements that allowed macroeconomic conditions as well as the circumstances faced by individual firms to be adequately reflected in wage contracts. It was agreed that this would promote wage moderation as well as wage differentiation.

Directors commended the authorities for the fiscal adjustment measures introduced in the past two financial years, which had contributed to a marked reduction in the budget deficit. However, they regretted the slippage in the implementation of the 1985/86 budget and stressed that the budget deficit was still rather high. Directors welcomed the detailed review of public expenditure policies undertaken by the authorities and the far-reaching reform of the tax system announced by the authorities in 1985. However, Directors expressed concern that, on present prospects, the fiscal outlook was uncertain and that the deficit to GDP ratio may rise in 1986/87, which they regarded as inappropriate. They urged the authorities to secure, without delay, further substantive cuts in expenditure to ensure an appropriate reduction in the public sector borrowing requirement. Thus, Directors urged that the budget for 1986/87 unequivocally confirm the restrictive fiscal stance that is essential to enhance the credibility of financial policies and to permit a trend decline in interest rates.

Directors remarked that the monetary aggregates had become difficult to interpret because of the sweeping deregulation and the ongoing innovations in the financial markets. While endorsing the policy of fully funding the public sector borrowing requirement, Directors pointed out that, to secure rapid progress in reducing inflation, it was essential for the authorities to demonstrate that monetary restraint would be firmly pursued. In that context, some Directors expressed concern about the continued buoyancy of the broad monetary aggregates.

Directors observed that the gains in competitiveness that had derived from the devaluation of July 1984 had been eroded to a significant extent, and they were concerned that, with the persistence of an unfavorable inflation differential, competitiveness might worsen further in the period ahead. Such a development could rapidly undermine the modest progress so far in reducing the external current account deficit and in avoiding a further rise in external liabilities. The containment of wage-cost pressures and the elimination of fiscal imbalances with a view to easing the upward pressure on interest rates and the exchange rate were therefore viewed as essential in order to strengthen competitiveness and to achieve a sustained reduction in the external current account deficit, which was particularly necessary in view of the high level of the external debt.

Directors commended the authorities for the progress made in reducing industrial assistance and import protection. Several Directors added, however, that the pace of restructuring in some sectors covered by industry development plans appeared to be somewhat slow and that import tariffs on a range of goods remained very high. Accelerating the pace of import liberalization would not only speed up the adjustment process in the tradables sector but would also help to dampen inflation and to distribute the adjustment costs more evenly across sectors. In particular, it would assist the farm sector, which already had to cope with the regrettable effects of growing protectionism abroad and weak commodity prices in addition to high interest rates, exchange rate developments, and the removal of subsidies.

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

2. SDR ALLOCATIONS - FIFTH BASIC PERIOD - REPORT BY MANAGING DIRECTOR TO BOARD OF GOVERNORS AND EXECUTIVE BOARD

The Executive Directors considered a draft of the Managing Director's report to the Board of Governors and to the Executive Board on the question of SDR allocations in the fifth basic period (SM/86/146, 6/19/86).

Mr. Polak commented that the Managing Director's report was a pro forma requirement under the Articles since he would have to state that there was no broad support for an allocation and that therefore he could not make a proposal at present but would do so when appropriate. However, there was more to the question than that. The impasse on allocations had induced the Interim Committee to ask the Executive Board to give serious attention to certain features of the SDR for the purpose of increasing its attractiveness and usefulness. The Board had undertaken that assignment and planned to begin work on the issue before the Annual Meeting of the Boards of Governors. The Managing Director's report should reflect that development. For that purpose, he suggested that paragraph 7 of the communiqué of the Interim Committee be included in the Managing Director's report, preceded by an explanatory introductory paragraph. 1/ It could also be mentioned that the Board intended to discuss the issues raised by the Interim Committee prior to its next meeting.

Mr. Nebbia said that, like Mr. Polak, he considered the Managing Director's report a pro forma step in accordance with the Articles of Agreement. He also considered that the report did not fully cover the previous year's discussion on SDR allocations. The Articles stated that there must be a long-term global need to supplement existing reserve assets before SDRs were allocated; a number of Executive Directors had maintained that that situation had existed for a long period of time,

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1/ See draft text in Annex.

whereas others disagreed. Thus, it was important to indicate the Managing Director's views and the position of the Fund, which was also that an allocation was needed; the difficult problem was how to achieve that allocation. According to Article I, one purpose of the Fund was "to facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment." It was in light of that Article that the Managing Director should state his personal position, reflecting the staff's views perhaps in his report to the Board of Governors.

Mr. Zecchini stated that he had no objection to the Managing Director's draft report, which described the situation in a formal but realistic way. He also had no objection to the proposal by Mr. Polak to insert paragraph 7 of the Interim Committee communiqué in the report. However, he considered that the introductory wording conveyed the impression that the Board was interested in introducing a new set of elements to decide the question of allocation whereas the question remained one of reaching a consensus for an allocation on the basis of existing rules. He would prefer to retain the introductory paragraphs of the draft report, followed by the quotation of paragraph 7 of the Interim Committee communiqué and the last sentence of Mr. Polak's proposal.

Mr. Lundstrom said that it would be appropriate to include the added text proposed by Mr. Polak. Moreover, he supported the inclusion of the introductory sentence suggested by Mr. Polak, which conveyed the correct impression.

Mr. Templeman said that he had no strong feelings about the inclusion of the paragraphs suggested by Mr. Polak. However, the introductory statement seemed to be an interpretation of what the Interim Committee had accomplished during its April 1986 meeting. For example, the sentence did not cite the monetary character of the SDR that was stressed in paragraph 7 of the communiqué. The introductory sentence of paragraph 3 of the original draft report should be retained, followed by the insertion of paragraph 7 as proposed by Mr. Polak.

Mr. Rye stated that he could support Mr. Polak's proposal. To avoid any problems of interpretation, he suggested that Mr. Polak's introductory sentence be inserted following paragraph 3.

Mr. Sengupta recalled that the Interim Committee's communiqué following the October 1985 meeting had included a crucial sentence reiterating that the SDR constituted an integral part of the structure of the Fund. That sentence had not been repeated in the April communiqué but should not be lost sight of and should be included in the present report. He would then have no problem with Mr. Polak's proposal and its amendment.

Mr. de Forges said that he supported Mr. Polak's proposal as amended.

Mr. Ismael stated that he supported Mr. Sengupta's proposal.

Mr. Templeman suggested that it would not be wise to include selective quotations from previous communiqués.

The Chairman commented that as the report was issued only every five years, it might be helpful to include some of the legislative input of the Interim Committee over that period.

Mr. Zecchini suggested that one solution would be to avoid quotations and to retain only the first sentence of paragraph 3 of the draft report together with the introductory section of Mr. Polak's statement.

The Chairman said that an alternative would be to make reference to the sections of the various communiqués that related to SDR matters.

The Director of the Legal Department noted that the 1981 report of the Managing Director had included a quotation from the Interim Committee's communiqué pertaining to SDRs, but only that part relating to SDR allocations.

Mr. Zecchini remarked that it was inappropriate to give so much room to comments that were not strictly and legally related to the allocation of SDRs; the expanded role of the SDR was not at issue in the context of the report.

Mr. Nebbia said that he had been informed that nothing prevented the Managing Director from expressing his own views in the report, although certain provisions did not allow the Managing Director to support a proposal when no consensus existed. If the two basic issues of whether there was a global need and whether a proposal for an SDR allocation was supported by the whole Board could be separated, the Managing Director's position--as well as that of his and several other chairs--could perhaps be reflected in the report. It would be appropriate to indicate the views on allocation of the management and of the institution, which was the ruling body of the international monetary system.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/86/103 (6/25/86) and EBM/86/104 (6/27/86).

3. AFRICAN DEVELOPMENT BANK (AfDB) AND AFRICAN DEVELOPMENT FUND (AfDF) - HOLDERS OF SDRS

1. Prescription as holders

The African Development Bank and the African Development Fund are prescribed, in accordance with Article XVII, Section 3(i) of the Articles of Agreement, as holders of SDRs.

2. Terms and conditions for acceptance, holding, and use of SDRs

The African Development Bank and the African Development Fund are authorized to accept, hold, and use SDRs in transactions and operations in accordance with and on the terms and conditions specified in Executive Board Decision No. 6467-(80/71) S, adopted April 14, 1980. ("Terms and Conditions for the Acceptance, Holding, and Use of Special Drawing Rights by Other Holders Prescribed Under Article XVII, Section 3.") (EBS/86/132, 6/18/86)

Decision No. 8318-(86/104) S, adopted
June 25, 1986

4. JAMAICA - OVERDUE FINANCIAL OBLIGATIONS - REPORT AND COMPLAINTS UNDER RULE K-1 AND RULE S-1

1. The complaints of the Managing Director dated June 20, 1986 on Jamaica in EBS/86/134 (6/20/86) are noted. They shall be placed on the agenda of the Executive Board for July 23, 1986.

2. The Fund urges Jamaica to become current in its financial obligations to the Fund promptly and to avoid thereby the need for the Fund to take remedial action.

3. Consideration of the complaints in accordance with Rules K-1 and S-1 particularly affects Jamaica. The member shall be informed by rapid means of communication of this matter and of its right to present its views through an appropriately authorized representative.

Decision No. 8319-(86/104) G/S, adopted
June 25, 1986

5. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director and by an Advisor to Executive Director as set forth in EBAP/86/148 (6/23/86) is approved.

6. STAFF TRAVEL

Travel by the Managing Director as set forth in EBAP/86/152 (6/26/86) is approved.

APPROVED: March 11, 1987

LEO VAN HOUTVEN
Secretary

3. At its meeting in Washington on April 9-10, 1986, the Interim Committee held a substantive discussion on the role of the SDR in the international monetary system and on possible improvements in the monetary characteristics of the SDR that would increase its attraction and usefulness as a component of monetary reserves. The Committee asked the Executive Board to discuss certain proposals and to report to it at the Committee's meeting on the progress of the Board's deliberations. The Communiqué issued by the Committee at the conclusion of that meeting contained the following paragraph on questions relating to the SDR:

> 7. The Committee noted the progress made by the Executive Board in studying the functioning of the international reserve system and the role of the SDR in a system in which borrowed reserves play so prominent a part, but are not now readily available to a number of countries with limited access to financial markets. It considered that the SDR, which is an owned reserve asset, can play a useful role as a component of international reserves and as a unit of account. It also recognized the potential use of the SDR as a "safety net" against unexpected contingencies. The Committee stressed the monetary character of the SDR, which should not be a means of transferring resources, and recommended that the Executive Board study possible improvements in the monetary characteristics of the SDR that would increase its attraction and usefulness as a component of monetary reserves.
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> The Committee again discussed the question of SDR allocations and determined that, although most members favored an allocation, the broad support needed for an allocation was lacking at this time.
>
> The Committee urged the Executive Board to continue its discussions on the role of the SDR in the present international monetary system and on SDR allocation in the light of proposals, aiming at the different possibilities of obtaining a more balanced and stable proportion of SDRs in members' reserves that have been put forward in that Board, and to report to the Committee at its next meeting on the progress in these discussions.

The Executive Board intends to discuss a number of the questions raised by the Interim Committee prior to the next meeting of that Committee.