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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/70

10:00 a.m., April 25, 1986

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	D. Saha, Temporary
C. H. Dallara	M. K. Bush
	M. Lundsager, Temporary
J. de Groote	H. G. Schneider
M. Finaish	T. Alhaimus
H. Fujino	
G. Grosche	
Huang F.	
J. E. Ismael	
	H. A. Arias
	R. Fox, Temporary
H. Lundstrom	
M. Massé	L. Leonard
	J. A. K. Munthali, Temporary
	M. A. Weitz, Temporary
	J. E. Suraisry
	L. P. Ebrill, Temporary
	S. Geadah, Temporary
	J. de la Herrán, Temporary
H. Ploix	S. de Forges
	J. de Beaufort Wijnholds
	A. V. Romuáldez
G. Salehkhou	
	A. S. Jayawardena
S. Zecchini	N. Coumbis

L. Van Houtven, Secretary
R. S. Franklin, Assistant

Also Present

European Department: P. B. de Fontenay, Deputy Director; P. Fontana, J. Khallouf, T. H. Mayer, P. Nagy, J. T. Reitmaier, G. Szapary. Exchange and Trade Relations Department: J. T. Boorman, G. Hacche. IMF Institute: S. El-Khouri, M. R. Rached. Legal Department: J. G. Evans, Jr., Deputy General Counsel; A. O. Liuksila, R. H. Munzberg, J. K. Oh. Middle Eastern Department: P. Chabrier, Deputy Director; S. H. Hitti, P. L. Joyce, M. F. Melhelm, K. Nashashibi, D. B. Noursi, C. Sassanpour, B. K. Short, M. Zavidgil. Treasurer's Department: T. Leddy, Deputy Treasurer; D. Williams, Deputy Treasurer; W. L. Coats, Jr., A. Tas. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: A. A. Agah, W.-R. Bengs, M. B. Chatah, P. Péterfalvy, I. Puro, D. C. Templeman. Assistants to Executive Directors: J. R. N. Almeida, M. Arif, B. Bogdanovic, F. Di Mauro, W. N. Engert, G. Ercel, O. Isleifsson, A. R. Ismael, H. Kobayashi, R. Msadek, J. E. Rodríguez, L. Tornetta, B. D. White.

1. AUSTRIA - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with Austria (SM/86/72, 4/4/86). They also had before them a paper on recent economic developments in Austria (SM/86/74, 4/11/86; and Cor. 1, 4/24/86).

Mr. Schneider made the following statement:

In 1985, economic developments in Austria were characterized by strong export growth but also by a marked strengthening of private consumption. Export growth of these dimensions was not anticipated, as earlier forecasts, based on uncertain international economic prospects, assumed that foreign demand would weaken. In the event, exports maintained their strength until the fall of 1985, but have been weakening since then. Private consumption was dominated at first by purchases of automobiles but subsequently purchases of consumer durables rose as well, reflecting the significant rise in real incomes. Nevertheless, as in other countries, the economic recovery was insufficient to fundamentally improve the unemployment situation. Regrettably, we have to accept the fact that a country like Austria, dependent on keeping pace competitively with the rest of the world, cannot afford large-scale independent strategies.

In the current year, developments are likely to be broadly in line with those in the other industrial countries--somewhat higher growth than expected, a further decline in the inflation rate, but only little change in unemployment (see table reproduced in Annex).

The hard currency policy continues to remain the cornerstone of economic policy. In an international economic environment characertized by sharp fluctuations, this strategy of seeking to stabilize expectations and prices is of fundamental importance to the Austrian economy. My Austrian authorities see no realistic alternative to this policy. The delicate structure of stable expectations, in particular, stands or falls with exchange rate policy. One of the preconditions for the credibility of this exchange rate policy is relative harmony, at least in the medium term, of the principal macroeconomic developments with those in other hard currency countries. There were some difficulties in this regard in 1984, because developments with respect to prices, the current account and the budget differed considerably from those in Germany. However, as expected, our inflation differential with Germany diminished significantly in 1985, facilitating our exchange rate policy and enhancing expectations of stability. In this context, developments in unit labor costs are of special concern, since the competitiveness of the economy's external sector is more directly affected by the trend in these costs than by consumer price developments. The trends in unit labor costs in manufacturing have been similar in Austria and Germany in recent years. Between 1982 and 1984, unit labor costs rose slightly less in Austria than in Germany, but in 1986, as last year, they are likely to rise somewhat faster in Austria.

The situation with respect to capital flows was of some concern in 1985, as there were large capital outflows as a result of purchases of securities denominated in foreign currencies. To stem these outflows, the central bank, toward the end of the year permitted short-term interest rates to rise and also encouraged a rise in long-term interest rates. This led temporarily to a substantial diversity of interest rates on the money market and to a rise in interest rates in the bond market from 7 1/2 percent to 7 3/4 percent.

To achieve stability of the basic monetary conditions given the exchange rate objectives, an increasingly flexible monetary policy has to be pursued. The purchases of foreign securities by domestic nonbanks are as much a symptom of the close interdependence of the financial markets as is the steep increase of purchases of domestic schilling securities by foreigners. Especially in the last few months we have seen how very strongly this market reacts to interest rate fluctuations. This is a reality we have to live with.

Fiscal policy in 1985 aimed at the continuation of the budget consolidation process by concentrating on the expenditure side and, where necessary, to shift financing requirements for needed structural adjustment from low priority to high priority programs. As part of this program the pension insurance system was reformed lowering the federal subsidies for social security. To promote equity capital formation, tax incentives for the purchase of newly issued shares were approved. At the same time, the double taxation of corporate dividend payments was eliminated. In the area of environmental protection, revenue-neutral incentives to use low-polluting automobiles were created. The effects of the "automatic stabilizers" were weakened by the favorable price developments and the fact that the upswing was led primarily by export and investment demand.

Nevertheless, in spite of these efforts, the expenditure/GDP ratio increased somewhat in 1985 and the deficit, in relation to GDP, remained at the 1984 level of 4.4 percent of GDP.

In 1986, the budget consolidation efforts will continue. The main elements of the 1986 budget are a general curtailment of expenditure growth and an adjustment of the expenditure structure to changing needs. The room for budgetary maneuver has been widened by the reduction or expiration of low-priority programs. Budget execution will again be rigorous in 1986. The implementing regulations call for restraint in the area of discretionary spending and for restrictive personnel management. Expenditure shortfalls and revenue increases above the estimates are to be used to reduce the deficit rather than being put to other uses.

The Austrian authorities are confident that through a rigorous budget execution the 1986 deficit can approximately be kept at the level of 1984-85 in relation to GDP. This may not appear to be a major achievement, but one has to keep in mind the following considerations: the longer-term effects of the stimulatory fiscal policy in 1982-83 are still burdening the budget. In addition, while the consolidation of public finances has high priority, it would be unrealistic to expect that this can be achieved in a very short time, particularly since 1986 is a pre-election year. Also, in the international context, Austria has a favorable position. Finally, without denying the need of convergence with Germany of medium-term fiscal trends, this does not necessarily mean a reduction in Austria's budget deficit to the current German level. In other words, convergence does not imply that economic developments in both countries have to be parallel at all times. We have had some deviations in the past and they will continue to exist. The authorities are thus confident that the budgetary problem remains manageable.

Austrian economic policy accords special significance to two longer-term goals--improvement in the industrial structure and environmental protection. Reacting to the difficult times some industries are now experiencing, the Government has adopted several rehabilitation programs to help especially the nationalized industries to adjust their structure to the changed market conditions. Direct transfers to the OeIAG--the holding company for most of the nationalized industries--were granted in addition to the S 16 billion approved in 1983 to assist in their rehabilitation.

Basically, the nationalized industries have been beset by two problems: First, diversification into other business areas has, in some instances, proceeded too fast and, second, there were organizational problems. It is now the intention of the Government to keep these companies clear from political interference. In this context, the Austrian authorities confirmed the policy to close companies which will not have become profitable after a certain time period. In addition, in early April 1986 a new OeIAG law was passed, which seeks to facilitate the restructuring of nationalized industry. To this end, it confers upon the managing board of the group holding company far-reaching powers for the control and coordination of companies' plans and the financing and personnel planning of their subsidiaries. The OeIAG can henceforth give instructions to the individual companies in these matters.

To sum up, economic policies have become more and more complex in recent years. Economic conditions are changing rapidly, raising questions and problems that require immediate actions. However, due to the changing circumstances and increasing uncertainties less reliance can be placed on past economic relationships as a guide for decision making. This situation poses a continuous challenge to policymakers at all levels.

Mr. Grosche observed that in 1985, Austria's economic performance had been generally favorable, particularly by comparison with performance in most other European countries. Overall growth had accelerated, while inflation had receded and the current account position had improved. The hard currency strategy had been instrumental in Austria's economic success over the past decade, and the Austrian authorities saw no realistic alternative to that strategy, which had proved its usefulness. It should nonetheless be emphasized that continued pursuit of the strategy required a strong convergence in fundamental economic conditions and policies between Austria and the neighboring hard currency countries; recent developments in fiscal and wage policies had raised some questions about the sustainability of the hard currency strategy in the medium term. Mr. Grosche fully shared the staff's view that policy changes would be required to successfully maintain that strategy, a requirement he was confident would be met on the basis of the pragmatic cooperation among the social partners that had proved to be successful in the past.

The main challenge facing the Austrian authorities in the years ahead was in the area of fiscal policy, Mr. Grosche continued. A significant divergence in fiscal performance between Austria and Germany had emerged in the past few years, and a further widening of the gap was in prospect for 1986. Apparently, Austria had been slower to embark on the process of fiscal consolidation than had many other countries. Mr. Schneider had rightly pointed to Austria's relatively favorable position and to the fact that consolidation required time; nevertheless, the process was in his view proceeding too slowly. Indeed, the authorities had succeeded only in stabilizing the deficit in 1985, and the budget for 1986 foresaw a slight widening of the deficit/GDP ratio.

The need for fiscal consolidation had been further underscored by public pressure for a personal income tax cut in 1987 to adjust for fiscal drag since the previous adjustment in 1982-83. Hence, the deficit reduction must focus on the expenditure side, and particularly on the effort to reduce the burden placed on the budget by the nationalized industries. He was happy to note that the authorities envisaged a number of measures to cut expenditures.

Also welcome was the progress made in restructuring exports, as evidenced by the recent shift toward finished goods and an improved current account position, Mr. Grosche said. However, Austria's economy continued to rely heavily on basic and semifinished goods and thus remained atypical of a highly developed industrial country. That reliance could help to explain in part why Austria had benefited comparatively less than neighboring countries from the demand-pull effects of the overvalued U.S. dollar. Further efforts to restructure the export base thus appeared necessary.

Unit labor costs in Austria had by and large paralleled those in Germany in recent years, Mr. Grosche observed. However, they had risen faster in Austria in 1985. Because the Autumn 1985 wage rounds in Austria had resulted in substantial wage increases of 5-6 percent, it was essential for the authorities to prevent a further divergence in labor cost trends, and moderation in future wage negotiations might become necessary. For 1986, overall prospects for the Austrian economy seemed generally favorable, although much would depend upon the effects on economic performance of the oil price decline and the fall in the U.S. dollar as well as on the extent of interest rate reductions in Austria. In that regard, he noted that the National Bank had allowed interest rates to rise toward the end of 1985 to stem the outflow of capital and the loss of reserves. The current account surplus projected for 1986 could lead to an easing of the present interest rate policy stance; however, the National Bank must ponder carefully whether an increase in foreign reserves--which had fallen to the lowest level since 1980--might not be preferable to forced interest rate reductions. Finally, he welcomed the authorities' intention to enact a new banking law to strengthen the profitability and capital base of commercial banks. The gradual erosion of that base over the past year had been a matter of concern.

Mr. Leonard noted from the staff report that the Austrian economy had performed well in 1985 and that prospects for the near term were reasonably good. At the same time, he had observed that the economic recovery had been insufficient to improve in a fundamental way the unemployment situation, and he could understand Mr. Schneider's view that a country like Austria could not afford large-scale independent strategies to promote economic activity.

All indications were that the authorities' hard currency policy had served the economy well, Mr. Leonard continued. The maintenance of a close relationship between the Austrian shilling and the deutsche mark had provided a firm and effective reference point that had acted as a catalyst for adjustment and for the maintenance of sound macroeconomic policies. For the hard currency policy to be sustainable, however, fiscal performance in Austria must converge with that in Germany. He was thus concerned about the widening fiscal deficit in Austria, which, if not corrected, would undermine the hard currency policy and the stability that it provided. Increasing interest rates in order to maintain the external value of the shilling did not appear to be a satisfactory response to the difficulty, as such an approach must ultimately contribute to the growth of the fiscal deficit by increasing interest costs and undermining domestic growth. Similarly, continued foreign borrowing to finance the deficit was not a sustainable option. Taking into account the low-income elasticity of the Austrian tax system, it appeared that a more permanent solution must be based on structural action to reduce expenditures and promote revenues.

An obvious focal point for attention in the effort to reduce expenditure was the existing network of support for state enterprises, Mr. Leonard commented. While the declared aim of all subsidies to enterprises was the promotion of structural change, a number of older programs of fairly general application remained in effect and might be regarded by the recipients more as income support than as inducements for structural change. Close scrutiny of those programs should be fruitful in identifying expenditures that could be eliminated without any loss of efficiency in the industrial sector.

The nationalized industries also appeared to include several loss-makers that imposed a large and growing burden on government finances, Mr. Leonard noted. The Government's efforts to streamline management in those industries was to be welcomed, but there might be a need for greater resolve in the pursuit of improvements in financial performance. On the one hand, the authorities had set deadlines for companies to become profitable and had publicly stated that there would be no further rescuing of public enterprises; on the other hand, the staff report indicated that the Austrian Government did not intend to apply the profitability deadlines mechanically. As he saw it, a failure to apply those deadlines rigorously, even though there might be justification for flexibility in particular instances, was likely to undermine the credibility of the Government's stance and ultimately lead to even greater difficulties in achieving fiscal goals.

He was also concerned by the authorities' reluctance to move toward privatization of nationalized industries, Mr. Leonard said. It appeared that the authorities felt that efficient management and profitability were unrelated to industrial organization and ownership structure, a point of view that was often disputed essentially on the grounds that, while private firms in competitive markets were compelled to be efficient in order to survive, the constraint was less binding for publicly owned firms and for firms in uncompetitive markets. It could be that the pursuit of profitability through greater managerial efficiency in the nationalized industries would prove to be a goal from which the Government would have to retreat at great fiscal and economic cost. While he was sensitive to the political problems faced by the authorities with respect to privatization, he was not convinced by the authorities' argument cited on page 8 of the staff paper that privatization was undesirable because of the climate of uncertainty that would be created for employees in privatized industries. As he saw it, the security provided by loss-making inefficient public firms was essentially false, and dearly paid for by the taxpayer In the circumstances, he urged the authorities to diversify the industrial sector toward more finished goods--so that alternative employment opportunities could be created for displaced workers--and to close firms that failed to show profits. He would also suggest that the authorities move toward privatization where the opportunity arose. Finally, while a curtailment of expenditure was necessary to improve Austria's fiscal balance, such action alone might not be sufficient. Hence, he encouraged the authorities to pursue measures to improve the bouyancy of the tax system, including a possible reduction in tax exemptions.

The National Bank's use of more flexible short-term open market operations to influence the money market rate was welcome, as was the intended banking legislation aimed at strengthening the capitalization of Austrian banks, Mr. Leonard commented. On the gentlemen's agreement concerned with limiting the open deutsche mark positions of the commercial banks, he took it that the reason for the agreement was to reduce the difficulties of reserve management in the event that banks suddenly decided to close their open deutsche mark positions. He wondered whether the new provision could be interpreted as indicating that the hard currency policy and other aspects of Austrian economic policy were not fully consistent. Finally, on the agreement between the banks and the authorities to limit competition in the banking industry, he agreed with the staff that the low profitability and weak capitalization of the banks might well be the result of a tendency on the part of the Austrian authorities to protect financial enterprises that might not be fully efficient and competitive. He endorsed the staff's view that the authorities should work to restore competitiveness in the banking industry, adding that failure to do so might ultimately compound the difficulties experienced by Austrian banks.

Mr. Ebrill noted like others that Austria had experienced steady growth in the past decade, a trend that was expected to continue in 1986. At the same time, unemployment was relatively low, and the rate of inflation was projected to be only 1.5 percent in 1986. The authorities deserved commendation for having adopted policies appropriate to the economic circumstances of the country. For the future, they would face the task of sustaining the pace of balanced economic expansion; while the basic thrust of economic policy was sound, successful achievement of that task might require some policy adjustments.

Historically, the centerpiece of Austrian economic policy had been the so-called social partnership, Mr. Ebrill continued. More recently, that partnership had been supplemented by a commitment to a hard currency strategy in the form of an effectively fixed exchange rate between the shilling and the deutsche mark. The fixed exchange rate policy in turn had implications for the conduct of economic policy more generally, both in the short and in the longer run. In the longer term, continued convergence between Austrian and German economic policies was essential, and it was in that context that the conduct of fiscal policy in Austria was particularly important. In recent years, fiscal deficits had been relatively high, especially given the demand for savings implied by Austria's traditionally high investment to GDP ratio. If those deficits persisted, pressures would tend to emerge elsewhere in the economy. It was encouraging to note in that respect that the authorities were committed to restraining actual government expenditures as much as possible, although more might need to be done. Since taxation already absorbed some 47 percent of GDP, reliance on further tax increases to help close the fiscal deficit did not seem appropriate. It was perhaps more important to ensure that the existing tax burden was levied as efficiently as possible, and he noted in that regard that recent trends indicated that Austria's tax system was inelastic, apparently because of the relatively narrow base of some of the major taxes. Also, many tax rates were quite high and could result in disincentive effects, some of which were already evident in the case of direct income taxes, where high marginal tax rates were apparently resulting in significant tax avoidance behavior. The authorities should explore ways of limiting exemptions and broadening the tax base so as to permit reductions in tax rates.

Most of the burden of reducing the fiscal deficit should fall on expenditure cuts, Mr. Ebrill considered. The ratio of expenditures to GDP in Austria significantly exceeded the OECD average; in addition, that ratio had increased in 1985. Of course, some components of expenditure would tend to continue increasing; in particular, the demographic structure in Austria would place heavy demands on the social security system, in spite of recent welcome reforms. But those likely increases served to demonstrate the importance of reducing expenditures elsewhere. One area where further savings might be possible was in Government support of public enterprises. In that context, he welcomed the stated intention of the authorities no longer to rescue loss-making enterprises. Also welcome was the declared objective of tailoring subsidies to promote structural change. If those objectives were realized, the result should be expenditure reductions and a strengthening of the longer-term objective of reorienting Austria's production structure to new growth industries. The ongoing effort to attain that latter objective should encourage the growth of industries in which Austria had a clear comparative advantage.

Remarking on the social partnership, Mr. Ebrill observed that wage increases in Austria, like those in other countries, tended to be based on past inflation rates. With the underlying rate of inflation continuing to decline, the result in Austria's case could be real labor cost increases in the near term. The hope should be that those increases be as moderate as possible in support of efforts to reduce excessive reliance on old line traditional industries.

Developments on the monetary side, given the hard currency strategy in Austria, had tended to reflect developments on the real side of the economy, Mr. Ebrill said. The recent increase in relative interest rates served to underscore the need for further fiscal adjustment. While monetary policy thus far had been assigned an accommodating role, monetary management nonetheless continued to be important. He welcomed the legislative effort to strengthen the profitability and capital base of commercial banks, which he hoped would lead to enhanced competition in the banking system. Finally, Austria's creditable economic performance over the past decade showed the value of steady but sustainable progress, and it was in that context that the authorities should be encouraged in their efforts to reduce the imbalances that had emerged.

Mr. Wijnholds considered that the Austrian authorities had been successful in transforming their economy from one registering relatively ordinary levels of output and income during the 1950s and 1960s to a prosperous one in which per capita income levels had caught up with those in the more well off European countries. During 1985, economic performance had continued to be satisfactory, and the authorities should be commended for their achievements. During the 1984 Article IV consultation, some Directors had observed clouds on Austria's horizon, and those clouds appeared to have darkened in the past year. In the circumstances, the authorities should guard against delaying needed adjustments in policy for too long. In particular, the fiscal situation must be addressed, and he shared the staff's admonition that the successful hard currency policy could be endangered in the longer run if the fiscal deficit remained considerably larger than that in Germany. Returning to a policy of foreign borrowing by the Government might be tempting as a way to delay painful adjustment, but it could be only a short-term palliative. While he was inclined to take comfort in the authorities' stated intention to reduce the fiscal deficit to 2.5 percent of GDP in the medium term, he had been disappointed to learn that the 1986 budget foresaw a slight widening of the deficit in terms of GDP. Given the scheduled elections in 1987, the medium-term goal for the deficit appeared to be a long way off. As Mr. Schneider had observed, economic policy convergence between Austria and Germany did not imply parellelism in economic performance; however, he was concerned about the entrenchment of divergent trends in fiscal performance between the two countries that could in the longer run cause problems for Austria's hard currency policy.

Monetary policy had been geared toward maintaining exchange rate stability, Mr. Wijnholds noted. Considerable reserve losses had required a widening of the interest rate differential between Austria and Germany toward the end of 1985, although that widening need not be cause for alarm. The differential could after all decline, although that would probably require somewhat stronger and more confidence building policies by the authorities.

The staff had indicated that banks in Austria built up large open positions in deutsche mark, Mr. Wijnholds recalled. It was generally accepted that commercial banks should not incur large open positions in foreign exchange, and he therefore welcomed the agreement between the National Bank of Austria and the commercial banks to phase down the open positions in the course of 1986. Another positive development in the monetary area was the inclusion in the new banking law of limits on such open positions, and he endorsed the staff's desire to see free competition among the banks restored once the new banking law had been introduced.

The outlook on the external side was not unfavorable, particularly since lower oil prices should contribute to bringing about a current account surplus in 1986, Mr. Wijnholds said. However, the staff had observed that Austria's balance of payments remained vulnerable because of weaknesses in its export structure and a dependence on lower quality tourism, particularly in summer tourism, where Austria had been losing competitiveness to lower-income countries. He was inclined to agree with the authorities that an upgrading of tourism was likely to increase the long-run earning potential in that sector, and he was not too concerned about the short-term adverse impact on the balance of payments. On exports, the staff had rightly noted the concentration of Austria's exports in labor-intensive goods, although he himself was not only worried about that concentration. After all, export volume had increased by more than 10 percent in 1985, with a shift toward finished goods. Moreover, Austria's market share had grown continuously since 1980 and had increased by almost 7 percent in 1985. If some decline were to take place in 1986, that would not be cause for alarm. Nevertheless, he shared the staff's view that if the increase in unit labor costs in Austria were to outstrip that in Germany, wage moderation would be called for.

Mr. Fujino agreed that the performance of the Austrian economy continued to be favorable, with real GDP growth having increased by 1 percentage point to 3 percent in 1985 and with prospects for that rate to continue in 1986. Inflation had slowed through improvements in the terms of trade, and the external account remained nearly in balance. Particularly noteworthy was the rate of unemployment, which was low by comparison with unemployment rates in other European countries. Although the unemployment rate in Austria had doubled since the late 1970s, the underlying developments were relatively favorable; total employment had grown much more rapidly than in neighboring countries and had absorbed the faster growth of the labor force. The structure of the Austrian economy and the social partnership were instrumental in promoting the positive growth in employment; however, the high unemployment among youth casts a shadow over the future development and quality of the labor market. An effort should be made to absorb young people in active work in order to maintain the resilience of the economy.

The expansionary fiscal policy stance adopted in 1982 and 1983 seemed to have imposed less of a burden on the Austrian economy than on many others, Mr. Fujino continued. However, the high budget deficit--which had continued at 4.5 percent since 1984--and the difficulties the authorities had experienced in reducing fiscal expenditures demonstrated the problems the authorities were currently facing. Unless addressed with determination in a medium-term framework, the high fiscal deficit and the heavy burden of interest payments and transfers in budget expenditures could become points of vulnerability in the Austrian economy. In that respect, it was encouraging to note the authorities' intention to place higher priority on medium-term fiscal consolidation.

Another area of concern was the structure of Austrian industry which was mainly dependent on basic goods and labor-intensive consumer products, Mr. Fujino commented. In 1985, export growth was strong, and Austria had gained export market shares. However, in order to meet the changing needs of external demand flexibly, it was important to improve and shift the industrial structure to a more rapidly growing, high-technology sector.

The large share of interest payments and transfers in the budget pointed to the need to focus fiscal consolidation on the expenditure side, Mr. Fujino noted. The reform of the pension system aimed at increasing the contribution rate, and reducing expenditures through a modification of the pension base was a necessary step in the right direction. In his own country, in order to prepare for a rapidly aging population and a possibly heavy burden on the budget in the next decade, the authorities were streamlining the pension system to make it more viable. Also, while subsidies were always difficult to cut meaningfully, he was hopeful that the courageous efforts by the Austrian authorities to reduce railway, agricultural, and other subsidies would be carried out as intended.

He had noted with interest the gentleman's agreement between the Austrian authorities and the commercial banks to secure higher margins by setting maximum deposit rates and minimum lending rates, Mr. Fujino said. The agreement seemed inconsistent with the general trend toward deregulation in the financial markets. If low profitability was a reflection of inefficiency in some institutions, as the staff had suggested, the agreement would help to protect those inefficiencies. Further comment by the staff or Mr. Schneider on that matter would be appreciated.

Under Austria's hard currency policy--which was a key element in economic management--the continued high fiscal deficits and the financing of them seemed to have had an impact on the external balance because of the limited base of domestic savings, Mr. Fujino observed. Some external government borrowing was required to alleviate the pressure on the domestic interest rates and on international reserves. While debt service was posing no problems for Austria at present, external considerations in the medium term pointed to the need for fiscal retrenchment. He trusted that the authorities would be successful in achieving their aim of medium-term fiscal consolidation.

Mr. Lundstrom agreed with others that the Austrian economy had performed well in 1985, exhibiting accelerated growth, declining inflation, and an improvement in the current account. The overall performance of the economy compared favorably with that in most European countries, a development for which the authorities should be commended. For more than a decade, Austria had successfully achieved relatively rapid economic growth together with a high degree of price stability, low unemployment, and a satisfactory external position. Clearly, that outturn was not mainly the result of external factors, but could be attributed in large part to successful economic policies. The mainstays of those policies according to the staff had been the so-called social partnership and the hard currency strategy, concepts which could be understood as a mix of a pragmatic incomes policy and cautious financial policies, in particular, a restrictive monetary policy.

The policies he had mentioned had served the authorities well, Mr. Lundstrom continued. The social partnership in Austria had been instrumental in keeping a lid on cost pressures through a moderation in wage developments. The hard currency policy clearly required monetary and other fundamental economic conditions in Austria to act in concert with those in Germany in order to maintain a strong link between the Austrian shilling and the deutsche mark. A third important element in the Austrian policy mix was fiscal policy, where less success had been achieved. Following some improvement in 1984 and 1985, slippages were expected in 1986. Without doubt the major policy challenge facing the Austrian authorities lay in consolidating the Government's finances without compromising the achievements made in other policy areas. He agreed with the staff that increased external borrowing did not constitute a sustainable alternative to fiscal consolidation and that delaying such consolidation might increase its eventual cost and perhaps also reduce the authorities' ability to proceed in an orderly fashion if there should be, for example, a marked deterioration in the external environment.

There were signs that the lack of fiscal consolidation could jeopardize the hard currency policy unless interest rates were allowed to rise significantly, even to levels that could undermine growth through stalling investments, Mr. Lundstrom said. Interest rates had been allowed to increase at the end of 1985 in order to stem the significant outflow of capital and loss of reserves, and he would appreciate elaboration by Mr. Schneider or the staff on some of the authorities' explanations for the outflow of private long-term capital, mostly into U.S. dollars denominated assets. He wondered in that regard whether Austrians were acting on an illusion associated with the uncovered interest differential favoring dollar assets.

Industrial policy in Austria was worrying, as the nationalized industries appeared to represent a growing burden on the Government, Mr. Lundstrom commented. The holding company of the nationalized industries was projected to absorb 1.5 percent of federal government tax revenue in 1986, up from 0.5 percent in 1984. In addition, the most important of the nationalized companies had been experiencing financial difficulties, which suggested that a reconsideration of the authorities' policy toward the nationalized industries was warranted. He welcomed the effort to streamline the management of those industries and the public statement by the authorities that nationalized companies would no longer be rescued. It would be interesting to know whether privatization of some of the nationalized industries was also being given serious consideration. As he saw it, the authorities' feeling that they would be unable to sell those industries at a fair price unless they were restructured and strengthened was an indication that the public management of the industries left something to be desired. Also, he would welcome staff comment on the indication of the authorities that privatization of the nationalized industries could hurt employees.

The shift in exports toward finished goods seemed to signal that the efforts of the authorities to restructure the economy had begun to bear fruit, Mr. Lundstrom noted. The signal was a welcome one, although it was noteworthy that Austria's economy continued to rely heavily on basic and semifinished goods, in the production of which the nationalized industries played a dominant role. In sum, he was impressed by the continued good performance of the Austrian economy but was concerned that more needed to be done, especially in the areas of fiscal and industrial policy.

Mr. Huang commended the Austrian authorities for the rapid economic growth, high degree of price stability, low unemployment and good export performance that had been achieved over the previous ten years. It was apparent from the staff report that GDP growth in 1986 would continue at about the same rate as in 1985. The staff had also projected that Austria's terms of trade would improve, that inflation would continue to be low, and that unemployment--which was relatively low by international standards--would remain at about the same level as in 1985.

Large fiscal deficits resulting from stimulative fiscal policies adopted in the early 1980s to help Austria out of a recession seemed to be the major challenge to the authorities at present and could affect the macroeconomic equilibrium of the economy if the fiscal deficits continued to widen unchecked, Mr. Huang continued. He agreed with the staff that measures should be taken to reduce the fiscal deficits by focusing on the expenditure side; however, the impact of expenditure cuts on domestic demand and growth should be watched carefully, particularly given the projected weakening of foreign demand for Austrian exports. It was essential that the reliance of the nationalized industries on government transfers and subsidies should be reduced; however, any sudden removal of those transfers and subsidies was not recommended, since that could adversely affect not only the nationalized industries but also the stability of the macroeconomy as a whole. Also of concern were the possible consequences on employment of the authorities' decision not to rescue the nationalized industries or to privatize them, and the rise in unit labor costs, which could eventually erode Austria's competitiveness and weaken the balance of payments position. The authorities needed to adopt measures to prevent any deterioration in relative external competitiveness.

Mr. Dallara agreed with the staff that macroeconomic performance in Austria in recent years had generally been commendable. Real GDP growth of 3 percent in 1985--with a similar rate projected for 1986--coupled with a growth of gross fixed investment of 5 percent allowed for a favorable comparison between the Austrian economy and the economies of the rest of Europe. Also favorable was the unemployment rate of 4.5-5 percent in recent years. In fact, a modest number of jobs had been created in the past two years, while inflation at the same time had fallen from nearly 5.5 percent in 1982 to a projected 2 percent in 1986. Moreover, the current account of the balance of payments had been in rough balance for a number of years.

Despite the favorable overall economic record he had mentioned, the staff had come to the conclusion that policy changes were needed if Austria's basic economic strategy was to continue to be successful. Mr. Dallara remarked that he agreed with the thrust of that conclusion and with the suggestion that two areas--the fiscal accounts and structural problems--were deserving particular emphasis. With an actual or prospective fiscal deficit in the range of 4 percent to 5.5 percent of GDP in the five-year period 1982-86, and no sign of a decline in the immediate future, one would expect to see some negative impact on overall macroeconomic performance. Some of that negative impact had not yet been felt but it was likely to be in the period ahead. Economic performance indicated that large-scale financial crowding out had not yet occurred, although the growth credited to the private sector had been less than that credited to the Government. Where the effects of the fiscal deficits had emerged was in the area of interest rates and debt accumulation. For example, during 1985, demand for credit to finance the deficit had apparently played a part in the rise in interest rates. He wondered why Austria had not followed the German example when the discount rate had been cut in March. If it had done so, private investment and growth prospects might have been helped, and public expenditures might have been reduced. Interest payments on the public debt had been rising, not only in absolute terms but in relation to GDP, federal tax revenues, and federal expenditures. Interest payments of the general Government had risen from 2.5 percent of GDP in 1980 to 3.7 percent of GDP in 1986, and federal interest payments as a share of federal expenditures had risen from 6.25 percent to 9.5 percent in the same period. Those ratios and developments demonstrated the extent to which revenues were being pre-empted by the need to make interest payments on accumulated debt and the extent to which expenditure policy in future would be increasingly limited by that nondiscretionary element of public spending.

The buildup of both domestic and foreign debt had been substantial and would represent a constraint on future policies in Austria, Mr. Dallara noted. The staff had pointed out that upward pressure on domestic interest rates could for a period of time be reduced by foreign borrowing to finance the budget deficit, a development that had already been taking place to some extent. In the three years 1983-85, foreign financing had accounted for 16 percent of the federal government deficit. In 1986, the share of foreign financing was expected to rise to about 28 percent. In the meantime, total federal government debt had risen from 30 percent of GDP in 1982 to more than 41 percent in 1986. The staff's medium-term foreign debt projections through 1992 suggested that, if world oil prices recovered to near-1985 levels, both debt and debt service ratios could rise substantially above then 1985 levels. While such a medium-term scenario might not materialize, and although Austria's debt figures were by no means in the crisis range, the direction of movement and the absolute size of the ratios demanded close attention and should be a source of concern to the authorities.

The staff had mentioned that the Austrian authorities did not believe that they could take substantial corrective fiscal action until 1987, Mr. Dallara observed. While politically understandable, any delay in the fiscal adjustment might well increase its cost and reduce prospects for an orderly outcome. Indeed, he wondered whether the authorities fully shared his concerns and those of the staff regarding the costs of delay over the medium term. Perhaps in the late 1970s and early 1980s Austria had been able to follow policies comparable to those in other key trading partners; more recently, however, performance in other industrial countries had improved, and policies needed to be strengthened and consolidated, especially in the financial field.

The staff had already pointed to some revenue-raising and expenditure-cutting measures that might be desirable, Mr. Dallara commented. On the revenue side, a reduction in the marginal personal income tax rates could be helpful, and it was worth noting in that regard that general government revenues at present represented 47 percent of GDP while expenditures were approaching 50 percent of GDP. The staff had also pointed to a reduction in tax exemptions as another means of reducing the deficit, since lost revenues from tax exemptions averaged about 32 percent of federal tax revenues. Nonetheless, he agreed with the staff that the focus must be on expenditures, particularly on various transfers and subsidies, which not only contributed to the fiscal imbalance but also created economic distortions in the economy.

He was pleased to note that the authorities were determined not to engage in any further rescue operations for nationalized industries, Mr. Dallara said, and the new control procedures described by Mr. Schneider might help them achieve better management of those industries. Also, the fixing of deadlines for companies to become profitable or suffer liquidation was encouraging, although he wondered like others why privatization had not been considered as an option. In order to deal with the economic and fiscal problems likely to be experienced by Austria over the medium term, privatization might be necessary.

Constraints on monetary policy arising from open markets in Austria, and the need to achieve policy and performance convergence with a few key trading economies--especially Germany--made policy management in Austria a complex matter, Mr. Dallara remarked. Still, improvements and innovations in the financial markets--such as the initiation of the short-term open-market operations in 1985, the tax incentives for newly issued shares, the elimination of double taxation of dividends, and the introduction of new banking legislation--should be helpful. In particular, the effort to strengthen the financial position of the banking system was commendable although he could also support the idea that specific prudential measures needed to be balanced against the need to strengthen competition in the banking sector, inter alia, through the assurances of equitable treatment of foreign banks operating in Austria. In conclusion, he joined other Directors in noting that the Austrian economy had clearly been performing well. He had chosen to mention one or two potential problems only in the hope that the authorities would address them promptly so that Austria's good economic performance could be continued.

Mr. Romuáldez observed that the Austrian economy had for many years performed well by international standards. In the past decade, by comparison with most European countries, Austria had achieved relatively rapid growth, a high degree of price stability, a continuing low unemployment rate and a satisfactory external position. Moreover, prospects for 1986 were for a continuation of the positive pattern. The Austrian authorities thus deserved commendation, as their economic policies had been instrumental in achieving the successes he had described. Particularly notable in that respect were the social partnership and the hard currency policy.

Nonetheless, Austria was not without its economic problems, Mr. Romuáldez continued. An expansionary stimulatory program during 1982-83 had saddled the country with a large fiscal deficit, which the authorities at present were finding difficult to control. The federal government debt had reached nearly 40 percent of GDP in 1985, and interest payments on that debt had been nearly 20 percent of federal tax revenues. Such a large deficit could eventually weaken the country's external position. Moreover, the balance of payments remained vulnerable because of weaknesses in Austria's export structure and its heavy reliance on low-income tourism.

The nationalized industries also represented a growing burden on government finances, Mr. Romuâldez said, and he wondered whether or not the emphasis of those industries on the production of basic and semi-finished goods led to an efficient allocation of resources. The inflation differential between Austria and Germany had widened at the beginning of 1986, although the inflation rate was projected to decline to about 1.5 percent for the year as a whole. International reserves had declined significantly during the course of 1985 because of short- and long-term capital outflows. Moreover, monetary policy at present might be bearing an unduly large share of the task of maintaining Austria's hard currency policy, with the risk that interest rates could be pushed to unwanted levels. The range of problems he had mentioned could not be lightly dismissed, although the Board had at least three good reasons for being confident that the authorities would respond appropriately to the challenges. First, such problems were not without precedent in Austria and, as the record showed, the authorities had been able to overcome them in the past. Second, the hard currency policy acted as a catalyst for adjustment; indeed, it had prompted the authorities to respond quickly to changing economic conditions. By requiring convergence in fundamental economic conditions and policies with Germany, the hard currency strategy should continue to serve Austria well. Third, while the improved international conditions brought about by the decline in international oil prices should make adjustment easier, the authorities nonetheless seemed to be fully aware of the steps that must be taken to bring about the necessary adjustments in the economy. On the fiscal side, for example, they had adopted a medium-term objective of reducing the deficit of the Federal Government to about 2.5 percent of GDP, and they had already achieved their immediate goal of stabilizing the deficit. As for the goal of medium-term fiscal consolidation, the authorities seemed fully aware of the need to focus on expenditure reductions and to adopt a firm attitude toward the nationalized industries. His optimism should not be taken to suggest that the various policy adjustments highlighted by the staff would be made automatically or without cost. But the Austrian record of responding to challenges left him confident that the new situation would be approached with determination.

The positive signals he had mentioned led him to wonder about the staff recommendation that the next Article IV consultation with Austria should be held on the standard 12-month cycle, Mr. Romuâldez commented. It could be argued that Austria did not fall in the category of member countries requiring strict adherence to an annual interval between consultations. The country was not using Fund resources and did not face immediate economic and financial problems. Even if it was facing such problems, it seemed unlikely that they would pose a threat to the international monetary system. In the circumstances, an 18-month or 24-month cycle might be sufficient. Of course, if the authorities felt that Fund advice through annual consultations was important, he would not oppose their wish. In those circumstances, however, a smaller staff team might suffice.

Mr. Zecchini observed that Austria continued to distinguish itself with prudent economic policies and enviable economic performance. In 1985, real GDP had increased at a rate of 3 percent, while unemployment, at 4.8 percent, had remained relatively low by international standards and inflation had been subdued. Further positive developments were expected for 1986, partly fostered by a favorable international environment. Lower oil prices and improved terms of trade were expected to lead to a strengthening of domestic demand, a further decrease in the rate of inflation, and the emergence of a surplus in the current account in the balance of payments.

The staff had convincingly noted that the maintenance of the fruitful hard currency policy of linking the shilling to the deutsche mark required a harmonization of Austria's macroeconomic policies and cost performance with those in Germany, Mr. Zecchini continued. However, costs and fiscal developments tended to diverge in the two countries and, if not corrected, could undermine in the medium term the effectiveness of the hard currency strategy. Unit labor costs had increased relatively more rapidly in Austria than in Germany in 1985, and the trend could continue in 1986. The external competitiveness of Austrian goods could be weakened unless the trade-off between the hard currency policy and the social consensus was made to work in the direction of relatively lower cost increases and, consequently of the stabilization of the real effective exchange rate at its level at the beginning of 1985.

Because of more expansionary fiscal policies in Austria than in Germany in the past two years, monetary policy had borne the burden of implementing the exchange rate strategy, Mr. Zecchini noted. The result had been a firming of interest rates in Austria to an extent that could dampen economic activity and fixed capital accumulation, thereby weakening the economy's growth potential in the medium term. Furthermore, the fiscal deficit as a percentage of GDP was expected to increase in 1986, albeit modestly. The increase might be partly related to the fact that, as Parliamentary elections were scheduled for April 1987, there was some reluctance to tackle the problem decisively before that date. Nonetheless, he encouraged the authorities to pursue a timely policy of fiscal consolidation. In absence of corrective measures, revenues would tend to increase more slowly and expenditures expand more rapidly than GDP; hence some structural adjustments would seem to be called for in the tax system--in order to increase revenue elasticity with respect to GDP--and in the expenditure mechanisms to check the brisk tendency of outlays to rise. On the revenue side, he could support the authorities' initiative to reduce tax exemptions. As for expenditures, he had not found in the report precise indications of the authorities' plans, and he wondered whether the staff or Mr. Schneider could elaborate on the expenditure reducing measures under consideration.

Nationalized industries had of late been placing a significant burden on public finances and were expected to continue to do so in the near future, as indicated by the recent Voest-Alpine case, Mr. Zecchini remarked. He was pleased to see that the authorities had reiterated their intention to avoid future rescue operations of loss making public enterprises, and he supported the emphasis being given to improving the management of the public enterprises in order to increase their profitability rather than seeking their privatization immediately. If privatization were attempted at present, the enterprises would command low sale prices because of the financial difficulties facing individual firms. However, if the efforts of the authorities to make those enterprises economically viable were not to be successful after some limited period of time, the authorities should consider the possibility of selling the enterprises rather than simply closing them down.

A reform of banking regulations was underway to increase the stability of the financial system, Mr. Zecchini noted. The planned strengthening of the banks' capital base and the idea of putting ceilings on their open foreign exchange positions as well as on their exposure vis-à-vis single debtors were appropriate. The latter measures should specifically avoid excessive concentration of financial risks. Generally, the authorities should seek greater stability in financial institutions and greater operational efficiency, which should be achieved mainly through greater competition in the market place. In that respect, there appeared to be some difference of view between the authorities and the staff about the gentlemen's agreement reached in 1984 to limit competition among banks. The agreement had been viewed with some concern by the Executive Board on the occasion of the 1984 Article IV consultation, and its implications for market efficiency should be considered by the authorities.

Mr. Salehkhou, noting his agreement with the staff appraisal, remarked that overall economic performance as well as monetary and financial developments in Austria continued to be favorable by international standards. In 1985, output had grown more than in most European countries, inflation had declined, and the external current account position had improved, following a relatively small deficit in 1984. During the period 1974-85, the Austrian economy had registered a relatively rapid growth of 2.4 percent per year on average. Such comparatively favorable performance had, moreover, been combined with a high degree of price stability--as inflation had averaged 5.7 percent per year in the same period against 10.7 percent in the European OECD countries--a relatively low unemployment rate at 4.75 percent in 1985, and a satisfactory external position, with the current account in approximate balance for the past few years.

It was important to note that the Austrian economic achievements were basically attributable to a two pronged socioeconomic/monetary policy approach, Mr. Salehkhou continued. On the one hand, the effective implementation of the social partnership over the past 30 years had moderated cost pressures through consensus among labor unions, employers, and government, thus providing a favorable setting for price and wage policies. At the same time, by establishing a strong link between the Austrian shilling and the deutsche mark, the authorities remained committed to the hard currency policy that had led to a stable financial environment. It should be emphasized, however, that the successful maintenance of the hard currency policy over the medium term required a convergence in fundamental economic conditions and policies in Austria and Germany. Although the interest rate differential vis-à-vis Germany had narrowed to about 1 percentage point by end-1985, it had widened again at the beginning of 1986, due in part to the divergence in fiscal policy. It was clear thus that the continuation of Austria's favorable economic performance depended largely on the authorities' success in fiscal consolidation.

The 1986 federal government budget showed a slight increase in the deficit/GDP ratio, and he was pleased to note the authorities' instructions to keep discretionary expenditures below budget estimates, Mr. Salehkhou commented. Effective implementation of those instructions, coupled with a focus on decreasing expenditures in the basic deficit sectors, such as railways, agriculture pensions, and the nationalized industries, should help prevent a further widening of the deficit. The nationalized industries in particular represented a growing burden on the budget, and the authorities' efforts to strengthen management structures and their stated intention not to rescue loss-making enterprises in future seemed to be steps in the right direction.

While the Austrian economy continued to rely mainly on basic and semifinished goods for exports, the recent shift toward finished goods was welcome and should be encouraged, Mr. Salehkhou said. Finally, although official development assistance remained below Austria's own previous commitments, its relative progress toward increasing the level of ODA in 1985 closer to that in other OECD members was welcome, as was the bilateral technical assistance that Austria had provided.

Mr. Jayawardena remarked that while he was generally in agreement with the thrust of the staff paper, he noted that it had not explicitly been framed in the context of the previous consultation, and he wondered whether clearer instructions toward that end should not be issued. Like other Directors, he had been impressed by the positive achievements of reasonable economic growth, low inflation, low unemployment and improvements in the balance of payments in Austria. Apparently, the hard currency policy and the social partnership had worked well, although there were certain risks in maintaining a high and inflexible fiscal deficit. Clearly, the authorities should take a close look at expenditures, particularly transfers to the nationalized sector.

There was a long history of public ownership in Austria, and it was not possible to rationalize the role of the public sector using the fashionable ideological terms of nationalization versus privatization, Mr. Jayawardena continued. As he saw it, the role of nationalized industries was intimately linked to the social partnership, the cornerstone of Austria's economic strategy, and it was unclear how a reform of the nationalized industries could be undertaken without affecting that partnership. Perhaps a more pragmatic approach to the problem would be to encourage open, full-scale competition among industrial units within the nationalized sector on the basis of a zero burden on the taxpayer. Such an approach would also involve a rationalization of the complex subsidy incentive structure, which had the potential for creating substantial distortions. In that regard, he had been surprised to read that the system of subsidies accounted for more than 3 percent of GDP. Hence, a reform of the subsidy system might set the stage for an eventual diversification of enterprise ownership and a reduction in the tax burden. Merely creating profitability in the public sector--which many were inclined to support--might not prove adequate; and, as he saw it, the road to rationalization of the public sector lay through the social partnership.

He had noted with interest the observation of the staff and several of his colleagues that Austria was rather unique among high-income countries in that it concentrated heavily on basic goods and labor-intensive semifinished goods, Mr. Jayawardena remarked. The reason for that concentration seemed to be a legacy of nationalized ownership. Public enterprises generally tended to live in the past and, by their nature, were not particularly anxious to be innovative. As he saw it, a reform of the public enterprise system was vital to the future of the Austrian economy, and if the hard currency policy had become part of the social partnership, there was no reason why the desirable reform of the nationalized sector could not be included as well. Finally, he welcomed the efforts of the Austrian authorities to increase official development assistance.

The staff representative from the European Department recalled that several Directors had queried the gentlemen's agreement to limit competition in the banking system. The agreement had grown out of the consideration that some of the banks, particularly the smaller regional ones, had been unable to maintain a sound financial position in the face of competition from larger banks. In principle, the gentlemen's agreement served as a temporary measure to avoid ruinous competition that would have led to failures in some banks while the authorities were working on a new banking law that would set down fairly strict rules of operation. It was widely believed that when the new law was put into effect, some restructuring within the banking system would be unavoidable. With respect to Mr. Zecchini's perception of a difference of view between the staff and the authorities on that matter, he noted that the staff was not fully convinced that the gentlemen's agreement would be removed once the new law was put into effect. However, if nonviable financial institutions existed, it was in the authorities' own interest to move toward restructuring.

On why long-term capital outflows had continued into the dollar asset area, despite the exchange risks involved, the staff representative noted that the immediate impact of the introduction in 1984 of the tax on interest income--withheld at the source--had been a large capital outflow. That had since abated, but there remained the psychological impact of the tax, which required an approximately 1/2 of 1 percentage point higher interest rate on financial assets. Moreover, the authorities had explained, that a desire for portfolio diversification was coupled with what they had called a coupon illusion associated with high uncovered interest differential favoring dollar assets. But the authorities had suspected that the outflow for those reasons would slow or be reversed as perceptions of the markets became clearer.

Responding to questions on why the authorities wished to limit open deutsche mark positions, the staff representative observed that such positions had led to a worrisome mismatch of maturities, with the banks having brought in short-term capital to lend long term. Moreover, in most countries, the monetary authortities wanted to discourage or at least regulate the open foreign exchange positions of banks in order to limit exchange rate risks. Some Directors had asked whether the authorities' concern about the open deutsche mark positions implied doubts about the hard currency policy. In fact, the Austrian authorities had always been careful to state that the schilling was not formally pegged to the deutsche mark but only strongly linked to that currency. In that respect, open positions in deutsche mark carried an exchange rate risk from a bank supervisor's point of view, and it was a legitimate objective of the central bank to attempt to limit them.

On the areas for expenditure cuts, the authorities preferred to concentrate in general on those large blocks of expenditure that had been growing faster than, say, nominal GDP, the staff representative observed. Those included the pension system, agricultural subsidies, subsidies to the railways, and the nationalized industries.

The authorities had undertaken in 1984 some reform measures that had considerably reduced transfers from the Federal Government to the pension system, the staff representative noted. Those actions had not led to a stabilization in real terms because transfers, even after the reform of the pension system, had grown faster than GDP. However, the immediate effect of the reform had been to give the authorities some room for maneuver to work toward more structural changes that would include a revision of benefits and possibly the encouragement of greater participation in private pension schemes. For obvious reasons, that effort would probably be delayed until after the elections in April 1987. Subsidies to agriculture should also be checked or reversed. However, as was the case in other European countries, the effort to cut agricultural subsidies had political implications.

The nationalized industries would seem to provide the most promising area for expenditure cuts, the staff representative from the European Department continued; and the issue of privatization was one that must be considered. Directors would note that the authorities had not spoken very positively on the matter of privatization; perhaps Mr. Schneider could elaborate on why nationalized industries were at present considered so important in Austria. It was, of course, clear that some nationalized industries were in underdeveloped regions of the country where labor mobility was low; and closure of any of the firms there would create unemployment problems.

The staff representative from the Exchange and Trade Relations Department recalled that the issue of the appropriate cycle for Article IV consultation discussions was being mentioned more and more frequently in the Board. Some Directors apparently preferred a more flexible attitude toward the cycle for countries that did not pose major problems to the system, did not face immediate financial problems and/or were not using Fund resources. In an earlier discussion on surveillance, it had been decided that the largest 25 countries (by quota) should be on an annual consultation cycle, and Austria was 23rd on that list. That decision had not been challenged in the most recent discussion of surveillance; indeed, the general tone of that discussion, which favored strengthening surveillance mechanisms, seemed to represent an endorsement of the list of 25. In light of that guidance and the desire of some Directors at the present meeting to continue to be informed of fiscal developments and industrial restructuring in Austria, he sensed that a 12-month cycle remained appropriate. However, the staff would be guided by the wishes of the Executive Board.

Mr. Schneider, remarking that it might be helpful to take up the issues of fiscal policy and the nationalized industries in Austria in a broader historical context, noted that the Austrian people had been forced to cope with dramatic political and economic changes since the end of World War I when the Austrian-Hungarian monarchy had been split and the German-speaking part of that monarchy had formed the First Republic of Austria. From 1920 onward, economic developments in Austria had not been encouraging, and growing disagreements between the two political parties--the Social Democrats and the Christian Democrats--had resulted in the dissolution of the Parliament and a short civil war in 1934. Moreover, the economic crises of the early 1930s had had devastating effects on the Austrian economy. Following the so-called Anschluss in 1938, Austria had become part of the German Reich and had ceased to exist as an independent state until the conclusion of World War II in 1945. Even after that date, Austria had remained occupied by France, the United States, the United Kingdom, and the Union of Soviet Socialist Republics.

One of the important measures adopted at that time by the Parliament--and fully supported by both political parties--had been the two nationalization laws passed in 1946 and 1947, Mr. Schneider remarked. Under those laws, basic industries--the electric power industries and the three largest commercial banks at the time--had been nationalized in an effort to avoid their seizure by the occupational powers and to secure the orderly reconstruction of destroyed industries in the absence of any other alternative. The history he had recounted was intended to show the roots of the strong feelings that Austrians had at present for economic and social security and industrial peace. At present, there were almost no strikes in Austria, and the people were rather conservative, having a dislike for abrupt changes. In the circumstances, most decisions were taken on the basis of consensus and with the concurrence of the social partners. The social partnership represented one of the main pillars for the conduct of economic policy in Austria and helped to define the domestic political framework within which the Government could operate.

The attitude of the Government toward fiscal consolidation had changed in 1984, as evidenced by the fact that recent increases in unemployment had not been countered by a more stimulatory policy, Mr. Schneider observed. Nonetheless, the authorities wished to avoid any restrictive effects on economic growth and had thus worked toward stabilizing the deficit in terms of GDP. Once having achieved that objective, they would take a succession of small steps toward the consolidation target.

Directors should not be overly pessimistic about the influence of present budget trends on the hard currency policy in Austria, Mr. Schneider commented. In the wake of heavy losses in one of the largest of the nationalized industries, the Government had replaced the entire management with well-known experts, regardless of their political background. Moreover, a new company strategy was being developed and the capital base and financial structure of the industry had been restored, albeit at the expense of the budget. Furthermore, the holding company for the nationalized industries had been restructured, and the authorities had agreed that companies would be closed down after a certain period of time if they had not become profitable. Although the closure would not be effected mechanically, the very possibility of closure should change the long held view that there would always be enough subsidies from the Government to keep any inefficient companies afloat.

On the matter of privatization, the Austrian authorities considered that the ownership of shares in the nationalized industries was not nearly as important as efficient and profit-oriented management, Mr. Schneider observed. Besides, to privatize loss-making industries would mean forgoing a fair sales price. In that context, Mr. Jayawardena had rightly noted that any endeavor to privatize nationalized industries could have serious implications for the social partnership, and he could imagine privatization occurring only if a consensus emerged in favor of such an approach. It should, however, be noted that a public debate had been ongoing in Austria on the usefulness of at least a partial privatization, and the Government's position had softened over the years, particularly with respect to the national commercial banks in which the Government had already sold a part of its shares.

The question had been asked by Mr. Dallara why the reduction of the bank rate in March 1986 effected by the Bundesbank had not been followed by the Austrian National Bank, Mr. Schneider rcalled. To some extent, the different approach reflected the difference of budgetary developments between Germany and Austria. Moreover, following the lead of the Deutsche Bundesbank would not have been consistent with the Austrian effort to keep interest rates high. In any event, according to the latest information, the differential that had existed toward the end of 1985 had since disappeared, and Austrian money market rates at present were at about the same level as German money market rates.

Elaborating on the staff's explanation of the gentlemen's agreement between the Austrian National Bank and the commercial banks, Mr. Schneider noted that one reason for the agreement had been to change the attitude of the management of the commercial banks. From 1945 until 1977/78, interest rates on credits of and deposits with commercial banks had been virtually constant in nominal terms; as a result, balance sheet growth had been regarded as synonymous with profit expansion. By 1977-78, however, nominal interest rates had become much more flexible and market related, although the changes had not been immediately accepted by the banking community. In fact the Austrian National Bank, with the concurrence of the Minister of Finance, had had to push the commercial banks toward the gentlemen's agreement as a kind of bridge until the effective date of the new banking legislation in early 1987.

A number of Directors had expressed concern about developments in unit labor costs in Austria, Mr. Schneider observed. While the decrease in the inflation rate to 1.8 percent in March 1986 was a welcomed development, it could not compare with the reduction in Germany, where the inflation rate had been measured at 0.1 percent in March 1986. The authorities were aware that wage moderation was necessary, and they were working toward that goal for 1986. Finally, on the consultation cycle, he himself was not convinced that Austria needed to be on a 12-month cycle: indeed, he presumed that his authorities would have no objections to being placed on an 18-month cycle. However, those views had to be understood in the context of the rules that the Excutive Board had adopted with regard to consultation cycles.

Mr. Fujino asked whether a change from a 12-month cycle to an 18-month cycle would create any difficulties for the staff in analyzing fiscal policy.

The staff representative from the European Department replied that the Austrian budget was prepared on a calendar year basis, although the information made available outside consultations was fairly comprehensive.

The staff representative from the Exchange and Trade Relations Department reiterating his understanding of the Board's policy on consultation cycles, noted that the Chairman's summing up at the conclusion of the Board's review of surveillance in 1985 made reference to the fact that at least the 25 largest countries in terms of quota should be on an annual consultation cycle. A note of somewhat greater flexibility had been sounded in the 1986 review of surveillance procedures, which had set out certain other criteria for the annual cycle. However, the general trend of that discussion had been toward a strengthening of surveillance procedures, and the flexibility that had been noted by the Board in the 1986 review should be seen in that context. Because no explicit challenge to the list of 25 had been made in the most recent discussion, that list would seem to remain part of the Board's guidance on the issue at hand.

The Acting Chairman made the following summing up:

Directors commended the Austrian authorities for continued good economic performance. Growth accelerated in 1985, while the rate of inflation was reduced and the external current account deficit narrowed. There was a slight increase in the rate of unemployment, but it was noted that Austria's unemployment rate remained low compared with rates in most industrial countries, a result to which the social partnership had no doubt contributed. Short-term prospects were favorable for a continuation of relatively rapid growth, a further slowdown in inflation, and a strengthening of the external current account position.

Directors acknowledged the importance that the hard currency strategy had played in Austria, stabilizing expectations and prices and acting as a stimulant for adjustment. It was noted that this policy had served Austria well over the years, and Directors continued to endorse it. It was also noted that this policy required that over the medium term there be convergence in fundamental economic conditions and policies between Austria and Germany. In this context, Directors welcomed the reduction in the inflation differential vis-à-vis Germany, but expressed concern about the widening divergence in fiscal policies which, if not reversed, could eventually weaken Austria's external position, raising the question of whether the hard currency policy could be maintained without pushing up domestic interest rates to levels that, in the view of a number of Directors, would work to undermine investment and growth over the medium term.

While taking note of the timetable for elections in Austria, Directors stressed that fiscal consolidation in Austria should be accelerated. They noted with regret that the 1986 budget did not provide for a reduction in the fiscal deficit in relation to GDP, despite favorable economic prospects, and they observed that such a reduction would have contributed to a lowering of interest rates. They stressed that emphasis in the fiscal consolidation effort should be on the expenditure side, and they welcomed the authorities' intention to execute the 1986 budget in a rigorous manner. However, determined action was needed in future to check expenditure increases in certain large areas, especially subsidies and transfers to nationalized industries, the railways, agriculture, and the social security system. While it was clearly necessary to concentrate on government expenditures, measures to improve the buoyancy of the tax system--for example, by reducing tax exemptions--could also contribute to fiscal consolidation and thus help to slow the rapid buildup in recent years of domestic and external public debt in relation to GDP.

Directors noted with serious concern the growing burden of budget transfers to the holding company of the nationalized industries, as well as the setbacks suffered by the most important nationalized enterprise in 1985 and the additional budgetary burden that the reconstitution of the financial position of that enterprise will entail in the years to come. They welcomed the steps taken to address the underlying weaknesses of the nationalized industries, both in terms of a strengthening of management and restructuring of production. In that regard, they urged steadfastness in implementing the decision to end budget support to those industries at the preannounced times. Some Directors felt, moreover, that a selective privatization of public enterprises should not be ruled out.

Noting the more rapid increase in unit labor costs in Austria than in Germany in 1985--a development that was projected to continue into 1986--some Directors underscored the need for moderation in the next wage round in the fall of 1986 to avoid a strain on Austria's international competitiveness that could arise because of the weakness of Austria's export base and the recent effective real appreciation of the schilling, which was largely associated with the depreciation of the U.S. dollar. Directors took note of the recent shift in the composition of exports toward finished goods, which appeared to be the result of industrial restructuring, and encouraged the Austrian authorities to pursue with determination their efforts at restructuring output and exports, particularly in the nationalized industries.

Directors welcomed the reform of the banking law, which could contribute to a strengthening of the financial system. They hoped that, with the introduction of the new law, prudential arrangements would be appropriately balanced against the need to strengthen competition among banks, including foreign banks. Several Directors welcomed the setting of limits on the open foreign exchange positions of the banks.

Some Directors welcomed the progress made in 1985 in raising Austria's official development assistance in terms of GNP and expressed the hope that further progress could be made in the future.

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

2. LEBANON - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with Lebanon (SM/86/68, 3/28/86; and Sup. 1, 4/24/86). They also had before them a paper on recent economic developments in Lebanon (SM/86/75, 4/11/86).

The staff representative from the Middle Eastern Department noted that the staff had been informed by telex on April 23, 1986 that a decision had been taken at end March to modify the commercial bank reserve requirement in Lebanon. The former requirement had been equal to 22 percent of banks' deposits in Lebanese pounds, of which up to 10.5 percentage points could have been held in the form of special treasury bills, with the remainder to be held on deposit with the Bank of Lebanon. The new reserve requirement was equal to 11.5 percent of banks' deposits in Lebanese pounds, all of which must be held in the form of deposits with the Bank of Lebanon. In addition, banks must satisfy a portfolio requirement to hold treasury bills in proportion to their Lebanese pound deposits, ranging from 30 percent for deposits less than or equal to US$1 billion to 70 percent for deposits exceeding 3 billion. The staff understood that the effect of those changes was to absorb commercial banks' excess reserves while giving them a yield on their required holdings and providing financing to the Government.

Mr. Finaish made the following statement:

For more than a decade now, the Lebanese economy has been operating under extremely difficult conditions. Recurrent armed conflicts have caused a considerable loss of life and a massive destruction of socioeconomic infrastructure. The economy has been greatly fragmented, with the result that the flow of commerce and finance has been seriously disrupted. Political uncertainties and the lack of security have sapped business confidence and have caused trained manpower and capital to flow out. Under such conditions, the ability of economic policymakers to influence the course of the economy is inevitably limited. This is so not only because the security and political situation has become the dominant factor in determining the performance of the economy, but also because the range of effective policy instruments available to the authorities has been severely reduced. It is important, therefore, to keep these constraints in mind when reviewing economic developments in Lebanon in recent years, and also to recognize that public policy measures normally recommended to governments would remain seriously limited in their effect in this case unless the political and security problems were resolved.

I now turn to economic and financial developments during 1985 that are reviewed in the staff report. The general deterioration of the Lebanese economy over the past decade, which accelerated sharply following the Israeli invasion of 1982, continued in 1985. The persistent lack of security and heightened uncertainty about the future, along with a drop in remittances and other external inflows, led to a substantial decline in output and living standards over the past year. On the financial side, the outcome was even more striking, with the fiscal deficit reaching about twice its level in 1984, and interest payments on domestic public debt exceeding total fiscal revenue. Reflecting these and other developments, the inflation rate is estimated to have risen to about 60 percent in 1985.

In order to put recent financial developments in proper perspective, it is useful to recall that in the period 1983-84 the Lebanese economy was already coming under considerable financial pressures. On the one hand, foreign exchange receipts from workers' remittances, other services, and exports were declining steadily as a result of the deteriorating security situation and the changing economic environment in the region. On the other hand, the fiscal deficit was widening during the period due to continued difficulty in collecting taxes and fees, and the pressures on the Government to maintain basic public services and help alleviate some of the social and economic problems caused by the persistent conflict. Until late 1984, however, these financial pressures were, to a large extent, absorbed by a drawdown of the foreign exchange reserves of the central bank. As a result, the exchange rate of the Lebanese pound depreciated only marginally, imports did not experience any substantial decline and inflation was relatively low. In retrospect, it is clear that that situation was unsustainable. However, it should be remembered that some optimism regarding a political settlement of the conflict existed during that period--particularly in the early part. Thus, the motivation of policy was not so much to delay adjustment but to avoid the economic disruption associated with such adjustment which a settlement of the security and political problems would have made largely unnecessary.

By late 1984, however, as foreign exchange reserves had reached a record low level (equivalent to about 3 months of imports) and as the financial situation grew weaker, the course of exchange rate and reserve policies was altered to let the economy adjust to the underlying economic and financial pressures. As a result, the exchange rate depreciated sharply, losing half its value in U.S. dollar terms in just a few months. The impact of this development on the economy was quite dramatic as the available data for 1985 indicate. This, of course, is hardly surprising given the openness of the Lebanese economy and the overwhelming importance of the external sector.

The impact of the exchange rate depreciation can be seen in the dramatic decline in imports, estimated at about 40 percent in 1985, which, in spite of stagnant exports, resulted in an overall balance of payments surplus for the year. This was reflected in the augmentation of foreign exchange reserves by the central bank.

While the sharp depreciation of the pound led to a surplus balance of payments position, the focus of policy in 1985 had been to try to contain the impact of the exchange rate depreciation on the fiscal deficit and on domestic liquidity expansion, and thus prevent a vicious cycle of a sliding currency and accelerating monetary growth. As it turned out, the security and political constraints on the attempts to prevent a large increase of the fiscal deficit in 1985 proved insurmountable. The presence of several illegal ports along the coast made it extremely difficult for the authorities to increase revenue through higher customs duties. Although the exchange rate used to value imports for customs purposes was increased, the rate was kept below the market level because of the competition from unofficial ports. The authorities doubt that a further increase in the import valuation rate would have increased customs revenues. However, the collection of fees and charges on public services, such as utilities, continued to be hampered by the security situation. On the expenditure side, despite a continued freeze on public sector employment, the wage and salary bill increased by about 30 percent following the sharp depreciation of the pound and the ensuing jump in consumer prices. The increase in interest rates on treasury bills and in the volume of domestic public debt resulted in a doubling of interest payments in 1985. In addition, the lag between the depreciation of the pound and the adjustment of local prices of petroleum products in November 1985 led to a sharp increase in the petroleum subsidy. As a result of all these factors, the public sector borrowing requirement in 1985 was about twice its level in 1984.

In the face of this deteriorating fiscal position, the central bank had to rely on the policy instruments available to it in order to mitigate the impact of such a large deficit on domestic liquidity, the price level and the exchange rate. The active monetary policy followed in 1985 and early 1986 included: financing the entire 1985 fiscal deficit through treasury bill sales to commercial banks; increasing commercial bank reserve requirements from 17 percent to 22 percent and raising the penalty on shortfalls in bank reserves to 1 percent a day; raising the yield on treasury bills to about 22 percent annually; selling treasury bills directly to the public; and imposing a ceiling on commercial bank credit to the private sector. More recently, a decision was taken requiring commercial banks to hold treasury bills in proportion to their deposits. These measures had two main objectives. First, to absorb, to the extent possible, the liquidity generated by the large fiscal deficit, and second, to stem the tide of exchange rate speculation which excessive bank liquidity made possible. The authorities recognize, however, that the ability of monetary measures to offset the impact of the large fiscal deficit is limited.

In addition to the measures intended to absorb excessive liquidity and thus reduce the scope for exchange rate speculation, the central bank has followed an intervention policy which is aimed at smoothing out short-term fluctuations in the exchange rate. This has meant substantial foreign exchange sales at times, which however were often offset subsequently by equally large purchases. The central bank is committed to allowing underlying economic forces to determine the exchange rate trend.

> The outlook for 1986 is difficult to assess as economic performance will again depend greatly on the security and political environment. However, there are reasons to believe that financial pressures may ease somewhat compared to 1985. In contrast to a substantial petroleum subsidy in 1985, it is now likely that the petroleum account will register a surplus in 1986 mainly as a result of the domestic price adjustments of November 1985. This, together with the fact that wage and salary increases in the public sector are being kept below the inflation rate and the increased cautiousness in investment spending are likely to keep the public sector deficit at or below its 1985 level even in nominal terms. Moreover, the balance of paymants outcome in 1985 suggests reduced pressure on the exchange rate and thus on prices. This certainly does not mean that the financial situation can be fully stabilized without a more decisive action to reduce the budget deficit, nor does it mean that the performance of the real sector will experience a significant improvement. Until a solution to the volatile security and political situation is found, the best that can be hoped for is partial containment of economic deterioration. The Lebanese authorities remain confident that a rapid economic recovery can be achieved once the situation returns to normalcy.

Mrs. Ploix, noting that France was keenly interested in Lebanon's progress and would continue to support Lebanon bilaterally as well as through its participation in international institutions active in Lebanon, considered that the Lebanese authorities deserved commendation for their courageous and persistent efforts to mitigate the various economic and financial consequences of the prevailing conflict in the country. The impact on economic performance had been serious, with output having fallen by 50 percent from mid-1970 levels. In the circumstances, it was remarkable that the foundations of Lebanon's trade-based economy had not been completely eroded. The authorities must persevere in their effort to keep the economy open and must limit their recourse to foreign borrowing.

The prudential regulations in the banking system--including commercial bank liquidity and solvency ratios--must continue to be strictly applied, since it was through such regulations that partial reconstitution of reserves had been achieved in 1985, Mrs. Ploix noted. In present circumstances, the maintenance of a flexible exchange rate seemed to be appropriate, particularly to the extent that it allowed the central bank to maintain its reserves. It was to be hoped that Fund technical assistance missions could be reinstituted in Lebanon as soon as circumstances permitted, and that the aid consortium organized under the aegis of the World Bank for reconstruction operations would be revived and that the World Bank Group would lend substantial financial support to those operations. The events of the recent past in Lebanon showed the country's remarkable resiliency and human resources, which would need to be utilized to the fullest once the opportunity presented itself.

Mr. Geadah noted that unfortunately, political and security problems in Lebanon continued to impede economic activity. Capacity utilization was low, unemployment and inflation rates were high, a considerable proportion of the country's economic and social infrastructure had been destroyed, and foreign exchange reserves had fallen sharply, despite a depreciation of the exchange rate. And those extremely difficult conditions had worsened with continued domestic unrest. In the absence of a resolution of the security problems, the only option available to the Lebanese authorities was to minimize the disruptions facing the economy. They had in his view responded to the situation with courage and perseverance, for which they should be commended. However, the fiscal deficits had become large; indeed, it was projected that for 1986 the public sector deficit would amount to more than 80 percent of total expenditures. In the circumstances, strong efforts to reduce the deficit must be undertaken. Given the obvious problems the authorities faced in collecting taxes, large revenue increases could not be expected, although the base for customs taxation could usefully be increased by valuing items that had to be imported through the official port at current exchange rates. That having been said, any real progress in reducing the deficit must be made on the expenditure side. The authorities should be commended for having allowed the price of petroleum products to increase, thus eliminating re-exports, and their decision to continue the freeze in government hiring was appropriate. Equally important had been the cessation of the practice of treating the bookkeeping profits due to the depreciation of the Lebanese pound as budgetary receipts. Still, he encouraged the authorities to consider further expenditure cuts; in that respect, the present system of subsidies should be scrutinized closely.

Despite the sophistication of Lebanon's financial sector, one of the inevitable results of the fiscal deficits had been an excessive expansion of domestic liquidity, Mr. Geadah commented. Clearly, any improvement in the fiscal situation would directly alleviate those pressures, and the direct effects could be supplemented by other important measures. In that context, he welcomed the fact that the authorities had raised revenue ratios and widened the market for treasury bills. Given the importance that the banking sector had traditionally played in the Lebanese economy, the authorities should continue to preserve confidence in the system by maintaining solvency and liquidity ratios and provisioning against nonperforming loans.

The authorities should be commended for the flexible exchange rate policy followed in 1985 that had allowed a modest accumulation of reserves, Mr. Geadah said. However, the Bank of Lebanon had intervened heavily in support of the pound in early 1986, and official foreign exchange reserves had fallen sharply. Accordingly, the authorities should be encouraged to readopt the exchange rate policy followed in 1985. On a related matter, the authorities' reluctance to increase foreign borrowing and their willingness to maintain a free and liberal exchange and trade system were commendable. In sum, Lebanon continued to face serious problems, many of which were beyond the authorities' control. While a number of helpful measures had been taken, the economic situation would remain difficult so long as the current circumstances of conflict persisted. It was to be hoped that the authorities would succeed in their difficult task and that more normal conditions would prevail soon. Finally, he could support the proposed decision.

Ms. Lundsager remarked that the difficult political and security situation in Lebanon complicated effective policy management. The authorities had apparently been able to avoid a serious financial crisis--an accomplishment in present circumstances--but she was concerned that without stronger efforts to reduce the fiscal imbalances, inflationary and exchange rate pressures might become excessive. In fact, the substantial jump in the inflation rate in 1985 and the developments described in the supplement to the staff report--including the further depreciation of the Lebanese pound and the decline in official reserves--should be a clear indication of the importance of reducing the fiscal imbalances.

The authorities had made several recent improvements in fiscal procedures, including the steps taken in 1985 to discontinue the practice of drawing on the profits of the exchange revaluation account as a source of budgetary revenue and the measures adopted to enhance revenues by adjusting the exchange rate used for customs valuation, Ms. Lundsager continued. Moreover, an effort had been made to limit public sector wage increases, the authorities were continuing the freeze on civil service employment, and budgetary investment had been curtailed in light of fiscal constraints. In the previous consultation discussion, her chair had suggested that various budgets should be consolidated in order to better set priorities in light of resource availability, advice that applied as well to extrabudgetary spending. She would be interested in comments from the staff or Mr. Finaish on the possibility of providing some centralized supervision or coordination of the various budgets. On subsidies, the domestic petroleum price increases in 1985 should permit the petroleum account to run a surplus in 1986, but the authorities should consider additional measures to reduce other subsidies, recognizing, of course, the political sensitivities surrounding such action.

Monetary policy in Lebanon was complicated by the large financing requirements of the Government, Ms. Lundsager observed. Nonetheless, the authorities had been taking steps to slow monetary expansion and reduce pressure on the exchange rate. Additional increases in deposit rates could help in that regard. The effort undertaken in 1985 to improve the financial position of the commercial banks was welcome, although the authorities should continue to insist on adherence to solvency ratios. Also, it would be appropriate for the commercial banks to retain profits in an effort to strengthen their balance sheets, and provision against nonperforming loans. The aim of a number of measures she had mentioned was to reduce the incentive to convert local currency deposits to foreign currency. Official reserves were already at a low level, especially when viewed in light of the role that the level of reserves played in maintaining confidence in the Lebanese pound. Apparently, the authorities had only limited scope for intervening further in the foreign exchange market, as they had done earlier in 1986, and she recommended that they follow their traditional policy of nonintervention. In sum, the Lebanese authorities had taken some welcome steps to contain the financial imbalances of the economy, and the authorities should be commended for having maintained an open trade and exchange system and for having followed a cautious approach to foreign borrowing. Nonetheless, the openness of the economy implied that the domestic imbalances could have an immediate and forceful effect on the external accounts; hence, stronger action to remedy the fiscal situation was required.

The staff representative from the Middle Eastern Department, recalling the hope expressed by Mrs. Ploix that Fund technical assistance to Lebanon be resumed as soon as circumstances permitted, observed that both the Central Banking Department and the Middle Eastern Department had been maintaining a dialogue with the authorities on monetary policy, and particularly on the solvency ratios. As noted in the staff report, the solvency ratio that was to have taken effect in December 1985 had been postponed until June 1986, because the rapid depreciation of the Lebanese pound in 1985 had dramatically increased the pound value of the commercial banks' foreign assets, substantially reducing the ratio of capital to total assets. Several paths could be followed for dealing with the situation, including one mentioned by Ms. Lundsager, who had suggested that the revaluation profits of the commercial banks should not be distributed to shareholders but should be retained in special accounts to provide additional capital to the banks. Ms. Lundsager had also mentioned the possibility of consolidating various budgets. While the authorities could support such an approach, the current security situation had prevented the consolidation from proceeding.

The impact of the decline in international oil prices on the balance of payments in Lebanon had been varied, the staff representative from the Middle Eastern Department continued. The most important effect was the direct impact on oil imports. The staff had estimated a savings on the order of $200-250 million a year from the decline in oil prices, but an indirect effect would also be felt through the budget because the fiscal deficit and monetary growth would be reduced. Budget estimates produced by the staff suggested that, at the present level of international oil prices and at the exchange rate of LL 22.5 per U.S. dollar, the oil price subsidy no longer existed; indeed, it was converted into a surplus of approximately LL 1 billion. However, with no change in the oil price but a further depreciation of the Lebanese pound to LL 29 per U.S. dollar, a subsidy of approximately LL 1 billion would re-emerge. On the negative side, remittances from workers in neighboring countries could be reduced as a result of the impact of declining oil prices on economic activity in oil exporting countries of the region. The staff could not quantify the reduction, although it was possible that it could outweigh the positive effects, adding to the pressures on the exchange rate. If so, the projected positive effect in the budget might not occur and the subsidy might well re-emerge. The staff viewed the current situation with respect to oil prices as an opportunity for the authorities to flexibly adjust domestic prices for petroleum products, thus giving a small margin of revenue for the budget.

Mr. Finaish agreed that the Lebanese case was a special one in which the economic, financial, and security situation in the country limited the ability of the authorities to use normal economic tools to manage the economy. Over the past few years, Lebanon had lost nearly 4 percent of its population, output had fallen by 50 percent, and per capita income for 1985 had been only one third the level registered in the mid-1970s. Moreover, much of the economic and physical infrastructure of Lebanon had been destroyed, and the economy had been greatly fragmented. Of course, the Fund could advise the Lebanese authorities to do their best to minimize the damage of the present situation, but a durable solution to the country's problems required a change in the security situation, so that economic recovery could take place.

Among the problems mentioned by speakers was the large fiscal deficit, which the authorities were attempting to tackle, Mr. Finaish noted. It must be understood that the deficit was the result of the current security situation, as the Government had little control over its own territory. Directors had advised the authorities to increase revenues and, to the extent possible, to reduce expenditures. He wondered, however, whether raising the tax and tariff rates and utility charges would in fact increase revenue. If the authorities were unable to collect taxes and customs duties and utility fees, then it mattered little how those rates were set. The effort to increase tariffs by adopting a more realistic market exchange rate for import valuation, for example, was hampered because the Government was competing with a number of illegal or unofficial ports. In fact, some had argued that a better approach would be to eliminate customs duties altogether, in order to put the illegal ports out of business.

The authorities had taken some measures to reduce expenditures, Mr. Finaish commented, but there was a limit to what could be done in that area as well. Aside from interest on the public debt, the main expenditure items were the petroleum subsidy, the wage bill and investment spending. As he had noted earlier, the petroleum subsidy had already been eliminated, as domestic prices had been increased by 17 percent in the face of a decline in oil prices internationally. Of course, the decline in oil prices had an immediate short-term positive effect, but in the longer run, one had to worry about the level of remittances from the large number of Lebanese workers in neighboring countries. On the wage front, the authorities had adopted a freeze on hiring and had limited the increase in salaries and wages to a rate below the rate of inflation. In the area of investment spending, political considerations had to be taken into account. In Lebanon, the Central Government had limited control over its territory, and the only connecting link with different parts of the country, in many cases, was government spending. The Government must continue to pay the salaries of employees and to maintain certain essential services, particularly in the current difficult times. It was also important for the Government to maintain a link with the various regions in anticipation of the time when Lebanon would again be united. The points he had made were not meant to belittle the importance or necessity of reducing the public sector deficit but only to suggest that further reductions in that deficit would necessarily depend on developments in the security situation.

The Acting Chairman made the following summing up:

Executive Directors were in broad agreement with the views expressed in the staff appraisal for the 1986 Article IV consultation with Lebanon. It was noted that the country's economic problems stemmed largely from the disastrous effects of a decade of armed conflicts, which has led to a massive decline in real GDP, and speakers expressed appreciation for the difficult conditions under which economic policy in Lebanon had to be conducted. The authorities were commended for the courageous measures taken to reduce fiscal imbalances in 1985, but it was noted that the overall public sector deficit amounting to over 80 percent of total public expenditures was clearly unsustainable. The authorities were urged more carefully to scrutinize both budgetary and extrabudgetary expenditures, to strengthen the collection of certain taxes, and to improve budgetary and extrabudgetary procedures and controls.

It was noted with satisfaction that most of the public sector deficit in 1985 had been financed through the sales of treasury bills to commercial banks and that the Government had not drawn on the Bank of Lebanon's exchange revaluation account as a source of revenue. However, it was also noted that the considerable purchases of foreign exchange by the Bank of Lebanon had not been sterilized and that the result had been a rapid expansion in reserve money.

Directors welcomed the successive increases in reserve requirements, the restraints on private sector credit, and the approval of sales of treasury bills direct to the public. They urged the authorities to further increase interest rates to stem the shift into foreign currency deposits that was, together with the large fiscal deficit, reducing the effectiveness of monetary policy.

Directors welcomed the change in exchange rate policy that had occurred in late 1984 when the Bank of Lebanon abandoned its policy of large-scale intervention in support of the pound and began gradually to rebuild reserves. They urged the authorities to maintain a flexible exchange rate policy and expressed concern that the Bank of Lebanon had intervened quite heavily in the first quarter of 1986. Directors commended the authorities' continued adherence to a free exchange and trade system and their cautious approach to foreign borrowing.

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

The Executive Board then took the following decision:

1. The Fund takes this decision in concluding the 1986 Article XIV consultation with Lebanon, in the light of the 1986 Article IV consultation with Lebanon conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes with satisfaction that Lebanon maintains an exchange system which is free of restrictions on payments and transfers for current international transactions.

Decision No. 8264-(86/70), adopted
April 25, 1986

3. LEVEL OF FUND SDR HOLDINGS - REVIEW

The Executive Directors considered a staff paper on the review of the level of the Fund's SDR holdings (SM/86/70, 4/1/86).

Mr. Ismael indicated that he could support a reduction in the Fund's SDR holdings to SDR 1 billion. The proposed reduction was in line with the decision taken by the Board in March 1985 and was consistent with Fund experience prior to the general increase in quotas in 1983. In determining the target range of the Fund's holdings of SDRs, the staff had cited several factors which should be considered, and his chair found all of them to be reasonable. He agreed that, as a result of the substantial increase in transactions by agreement among members and the likelihood that such transactions would reduce demands on the Fund to make SDRs available to members for paying charges, a working balance of SDR 1 billion could adequately cover the Fund's need to hold SDRs. He was not unduly concerned about the implied reduction in the Fund's net income position as a result of a reduction in its holdings of SDRs.

Mr. Arias observed that the issue of the Fund's holdings of SDRs had been discussed thoroughly in reviews held in the early 1980s. The clear intent of decisions adopted at the conclusion of those reviews--particularly the decisions adopted in November 1984 and March 1985--had been to ensure an orderly reduction of the Fund's holdings of SDRs. In attempting to arrive at an optimal level for the Fund's SDR holdings, an appropriate balance must be struck between the Fund's operational and liquidity requirements and the need to promote the role of the SDR as an international reserve asset. Strengthening the role of the SDR had been emphasized of late as a way of helping to stabilize the international monetary system; it would also result in a better allocation of SDRs, a point which the Managing Director had emphasized in his summing up at the conclusion of the discussion on that issue in March.

In general, he did not find compelling the argument that a reduction in the Fund's holdings of SDRs would have an adverse effect on the institution's income position, Mr. Arias continued. As a result of increases in the remuneration coefficient in relation to the SDR interest rate, the financial effects in particular of a reduction in the Fund's SDR holdings had diminished. For those reasons, his chair could support the proposed decision.

Mr. Schneider indicated that he was in full agreement with the staff's method of assessing the adequacy of the Fund's SDR holdings, and he could support the proposed decision to aim toward a reduction of those holdings to approximately SDR 1 billion by May 1987. That proposed level of SDR holdings provided an appropriate balance between the Fund's need for SDRs for operational purposes and the need for members to hold SDRs rather than the Fund. The recommendation not to reduce the Fund's SDR holdings below the proposed level was justified by the fact that proposed holdings should provide the Fund with some additional net income, which would produce a slightly dampening effect on the rate of charge to be applied.

The proposed decision was properly in line with the policy adopted on the occasion of the previous review of the Fund's SDR holdings, Mr. Schneider continued. According to the staff, implementation of the decision would result in a different outcome with respect to the amount of SDRs to be used in purchases and payments to lenders; and, while the projected reduction of the Fund's SDR holdings for fiscal year 1987 would be somewhat smaller than the reduction proposed for 1986, the new decision would require significantly more SDRs to be used for transfers. The divergent pattern could be explained by the projected reduction of some SDR 9 million resulting from the acquisition of SDRs by members for payment of charges. In conclusion, it was clear from the staff paper that, over the years, the SDR had become an essential instrument in the management of the Fund's daily lending operations, both with respect to the transfer of resources among members and with respect to the settlement of charges and remuneration. That development deserved to be taken into account during the forthcoming discussions on the role of the SDR and on the appropriate amount of SDRs that should be created in order to allow the asset to fulfill its role.

Mr. Massé stated that he was among those who felt that the Fund's holdings of SDRs should be kept at relatively low levels in relation to total SDR allocations, and he had taken note of recent declines in those holdings. Since the staff believed that the operational needs of the institution could be adequately served by maintaining working balances of about SDR 1 billion, and since there were no reasons relating to the Fund's income or liquidity position to favor some other level of holdings, he could agree with the proposed decision to aim to reduce the Fund's SDR holdings to a level of approximately SDR 1 billion by May 31, 1987 and to review the level of SDR holdings again prior to April 30, 1987.

Mr. de la Herrán supported the staff proposal, which he found consistent with the Fund's income needs and liquidity position. He noted in passing that among the factors considered in determining the appropriate level of the Fund's SDR holdings was the ratio of those holdings to total allocations. If that ratio was an important indicator, the staff paper should include figures that took account of the possibility of further allocations; otherwise, the ratio could give the impression that no such allocations were contemplated.

Mr. Grosche stated that he too could support the proposed decision. He agreed with the staff that it was preferable that allocated shares of SDRs should be held in members' reserves rather than by the Fund and that, generally speaking, the Fund should not aim to hold a higher proportion of SDRs than was justified in light of its liquidity and operational needs. Income considerations also should not be the main criteria for determining the appropriate level of SDRs to be held by the Fund. Moreover, even those who might argue for such criteria would find that the financial effects of a reduction in the Fund's holdings of SDRs on the income position of the institution had diminished following the increase in the remuneration coefficient. Finally, he could endorse the proposal to give some emphasis to the use of SDRs during the first two operational budgets of fiscal year 1987, in order to speed up the effort to harmonize members' reserve tranche positions in the Fund.

Mr. Fujino observed that the staff had presented reasonable and balanced arguments for a reduction in the Fund's SDR holdings, and he had taken note of the staff's view that the operational needs of the institution could adequately be covered by balances of SDRs on the order of SDR 1 billion. In the circumstances, he supported the proposed decision to reduce the SDR holdings to SDR 1 billion by end-May 1987 and to review the relevant SDR holdings before April 10, 1987.

Mr. Suraisry remarked that he too could support the proposed decision.

Mr. Wijnholds considered the staff proposal to be appropriate, and he agreed with those who felt that income considerations were not relevant in determining the level of SDR holdings to be held by the Fund.

Mr. Weitz commented that, as in previous reviews of the level of the Fund's holdings of SDRs, his chair would again support the view that it was preferable for SDRs to be held in members' reserves rather than by the Fund, particularly when the relevant factors to be considered in determining the target range of the Fund's SDR holdings allowed the transferring of further amounts to member countries through operational budgets or other forms of disbursement. In the circumstances, the recommended decision to reduce the Fund's SDR holdings to SDR 1 billion by May 1987 appeared broadly appropriate.

The Fund's liquidity position should not be adversely affected by the proposed reduction, given the high level of usable currencies available, Mr. Weitz remarked. Moreover, operational requirements would seem to be covered by the recommended amount of SDR 1 billion as a working balance. Finally, the adverse impact that a further reduction of the Fund's SDR holdings might have on the institution's income position was nearly irrelevant, at least in terms of its implications for the rate of charge.

Mr. Zecchini said that he could support the staff's conclusions and the proposed decision. Agreeing that the Fund should not hold a higher proportion of SDRs than was required by its operational and liquidity needs, he had noted the staff's belief that a balance of SDR 1 billion was sufficient to carry out the institution's operations without constraints, although lower working balances in SDRs might not be prudent. The aim of reducing the Fund's holdings to SDR 1 billion by May 1987 was therefore acceptable. The reduction should allow for an increase in the SDRs to be held by member countries in their portfolios of international reserves, an outcome that would be consistent with the guidelines provided by the Interim Committee, which had indicated that the SDR, because of its reserve characteristics could play a useful role as a component of international reserves. The Interim Committee had also showed interest in proposals aimed at improving the characteristics of the SDR and at obtaining a more stable and balanced proportion of SDRs in members' reserves, objectives that could be made more attainable by an increase in SDR holdings by member countries.

Mr. Huang commented that he had no difficulty with the proposed decision, which was aimed at reducing the Fund's SDR holdings to a level of approximately SDR 1 billion by May 31, 1987. Given that developments in fiscal year 1987 were uncertain, it would seem prudent for the Fund to keep the average holdings for the year to a reasonable level so as not to adversely affect its income position.

Mrs. Ploix, Ms. Bush, Mr. Jayawardena, and Mr. Romuáldez indicated that they could support the proposed decision.

The Deputy Treasurer noted that in making a reference in its report to the ratio of the Fund's holdings of SDRs to total allocations, the staff had intended to suggest only that those holdings should not be too large a proportion of the total; there had been no intention to suggest that the staff had any particular standard in mind or that the proposed reduction in the Fund's holdings of SDRs implied some staff view about the amount of SDRs that should be outstanding in total.

The staff representative from the Treasurer's Department agreed with Mr. Schneider that the staff projection for sales of SDRs by the Fund to members for the coming year was significantly below the amount in the previous year. However, the projection for 1986 was for an amount larger than any amount that had been sold to members for charges in any other year except 1985, when the amount sold had been unusually large because of the need to make up for slippages in purchases of SDRs by members. It was not that members had needed to turn to the Fund as a source of SDRs, but that the Fund had used the sale of SDRs to meet its target for holdings of SDRs as a result of the falloff in the use of SDRs in purchases.

The Executive Board then took the following decision:

In determining the amounts of SDRs to be transferred in purchases under the operational budgets, the Fund will be guided by the aim of reducing the Fund's SDR holdings to a level of approximately SDR 1 billion by May 31, 1987. Prior to April 30, 1987, the Fund will again review the level of its SDR holdings.

Decision No. 8265-(86/70), adopted
April 25, 1986

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/86/69 (4/23/86) and EBM/86/70 (4/25/86).

4. BOTSWANA - 1986 ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to extend the period for completing the 1986 Article IV consultation with Botswana to not later than May 7, 1986.

Decision No. 8266-(86/70), adopted
April 24, 1986

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/86/96 (4/22/86) and EBAP/86/97 (4/23/86) is approved.

APPROVED: January 20, 1987

LEO VAN HOUTVEN
Secretary

In its latest forecast of April 1986, the Austrian Institute for Economic Research has further revised upward growth projections as had been anticipated in the staff report. This revision reflects the sharp decline in oil prices and the fall of the U.S. dollar and is based on the assumptions for 1986 of an average oil price of US$16 per barrel and an exchange rate of S 15.50 per U.S. dollar.

	1984	1985	1986
		(Change in percent)	
Real GDP	2.0	2.9	3.0
Private consumption	-0.8	2.2	2.8
Gross fixed investment	2.0	5.3	4.8
Exports of goods and services	3.5	10.4	3.0
Imports of goods and services	7.7	8.8	4.8
Trade balance (in billions of schillings)	76.8	- 65.3	-53.7
Current account balance (in billions of schillings)	-3.9	-2.0 *	8.6
Consumer prices	5.6	3.2	2.0
Unemployment rate (in percent of dependent labor force)	4.5	4.8	4.9

* Preliminary figure.