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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/93

10:00 a.m., June 10, 1985

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
A. Alfidja	
C. H. Dallara	E. L. Walker, Temporary
J. de Groote	H. G. Schneider
	X. Blandin
	T. Alhaimus
H. Fujino	M. Sugita
G. Grosche	B. Goos
J. E. Ismael	
	L. Leonard
	J. R. N. Almeida, Temporary
	H. Fugmann
E. I. M. Mtei	A. Abdallah
	J. J. Dreizzen, Temporary
Y. A. Nimatallah	
	G. R. Castellanos, Temporary
	J. E. Rodríguez, Temporary
J. J. Polak	J. de Beaufort Wijnholds
C. R. Rye	
G. Salehkhou	O. Kabbaj
	A. Vasudevan, Temporary
	T. A. Clark
	N. Coumbis
	Wang E.
	Chen J., Temporary

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

Also Present

D. Gill, The Treasury, New Zealand. African Department: I. C. Lienert. Asian Department: L. Mendras. European Department: B. Rose, Deputy Director; M. T. Hadjimichael, O. E. G. Johnson, S. M. Thakur, H. Vittas. Exchange and Trade Relations Department: J. T. Boorman, S. Kanesa-Thasan, G. Oliveros, P. J. Quirk. Fiscal Affairs Department: A. A. Tait, Deputy Director; G. Blöndal, D. C. McDonald. Legal Department: J. G. Evans, Jr., Deputy General Counsel; J. M. Ogoola, S. A. Silard. Middle Eastern Department: A. S. Shaalan, Director; P. Chabrier, Deputy Director; G. T. Abed, M. Arif, E. J. Bell, J. R. Dodsworth, F. Drees, M. A. El-Erian, S. H. Hitti, B. A. Karamali, K. Nashashibi, D. B. Noursi, M. Yaqub. Research Department: P. L. Clawson. Treasurer's Department: T. B. C. Leddy, Deputy Treasurer; J. E. Blalock, J. C. Corr, D. Gupta, D. V. Pritchett. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: A. A. Agah, E. M. Ainley, D. Hammann, S. M. Hassan, G. Nguyen, T. Sirivedhin, E. M. Taha, D. C. Templeman. Assistants to Executive Directors: H. Alaoui-Abdallaoui, M. B. Chatah, J. de la Herrán, G. Ercel, C. Flamant, R. Fox, G. D. Hodgson, L. Hubloue, A. K. Juusela, M. Lundsager, K. Murakami, A. Mustafa, J. K. Orleans-Lindsay, W. K. Parmena, M. Rasyid, J. Reddy, D. J. Robinson, C. A. Salinas, M. Sarenac, A. A. Scholten, L. Tornetta, A. J. Tregilgas, B. D. White.

1. SUDAN - OVERDUE FINANCIAL OBLIGATIONS - REVIEW OF DECISION TO LIMIT USE OF FUND'S GENERAL RESOURCES

The Executive Directors considered a staff paper reviewing the decision adopted on February 8, 1985 limiting Sudan's use of the Fund's general resources (EBS/85/145, 6/7/85).

The Director of the Middle Eastern Department said that the Minister of Finance and Economic Planning had recently held discussions with staff and management on Sudan's overdue obligations to the Fund and the need for adjustment policies to address the structural problems facing the economy. It was the staff's understanding that the authorities were negotiating with major donors to receive assistance in discharging Sudan's obligations to the Fund and that the finalization of arrangements with donors depended upon progress in the discussions on appropriate policies to address the serious economic situation in Sudan. The staff had urged the authorities to make every effort to utilize other resources to discharge their obligations to the Fund while the negotiations with donors were taking place.

The staff had discussed with the Minister the prospects for the adoption of appropriate policy measures, the need for which had been underscored by the latest data, indicating that the underlying economic conditions had worsened since the previous staff mission in March 1985, the Director of the Middle Eastern Department continued. The Minister had requested staff assistance for the authorities, who were determined to address the economic problems in a serious and prompt manner. A staff mission planned to visit Sudan soon with a view to assisting the authorities in evaluating the current economic situation and in formulating suitable economic policies. Implementation of those policies could pave the way for the major donors to provide assistance in eliminating Sudan's overdue financial obligations to the Fund which, in turn, could pave the way for negotiations on a stand-by arrangement covering the fiscal year that would start in mid-September 1985. Those negotiations would be followed by meetings of creditors and donors to consider debt rescheduling and additional assistance to cover the balance of payments financing gap. The staff planned to report to the Executive Board on the outcome of its mission soon after its return to Washington, when the next review of the situation in Sudan could take place.

Mr. Mtei said that the authorities were grateful for the Executive Board's postponement of the review of its decision of February 8, 1985 on Sudan's overdue obligations. The new Government was fully aware of the gravity of the problems facing the economy and was determined to tackle them by containing government expenditure and the high rate of inflation and by using scarce resources, including foreign exchange, more efficiently. The authorities attached considerable importance to normalizing Sudan's relations with the international financial community, including the Fund, and were aware that external support was essential for the success of their adjustment effort. They were evaluating the economic and financial situation in Sudan with a view to implementing appropriate policies under a comprehensive adjustment program.

Despite the continued political sensitivities in Sudan regarding the role of the Fund in that country, the authorities intended to remain in close consultation with the Fund over the coming period, Mr. Mtei continued. The Minister of Finance had recently held further discussions with staff and management. He had stated that the authorities hoped that the Fund understood that many of the problems facing the economy could be tackled only over the longer run and only with substantial concessionary aid from both donor countries and multilateral agencies. Since taking office in April 1985 the new Government had given top priority to eliminating Sudan's arrears to the Fund and had made some payments despite the very difficult economic situation in the country. The authorities had clearly made a strenuous effort to meet their obligations to the Fund.

The Government had received a commitment from the United States to contribute $50 million toward the settlement of Sudan's overdue obligations and had firm commitments from Arab countries to help eliminate the remaining arrears, Mr. Mtei noted. That package could not be finalized until the end of Ramadan. The authorities were committed to adjustment and were curbing public expenditures and taking other necessary fiscal steps. They had also agreed to proceed with discussions with the staff, and a technical assistance mission planned to visit Sudan in the coming days to review the relevant data. Another staff mission was expected to arrive in Sudan in the final week of June to provide additional assistance in formulating a program that could be presented to the Consultative Group and that would permit the authorities to negotiate a stand-by arrangement once the arrears to the Fund had been eliminated.

Executive Directors should bear in mind that Sudan had been severely affected by three consecutive years of devastating drought and the inflow of two million refugees, Mr. Mtei said. Payments to the Fund constituted a major part of Sudan's total debt service obligations. The amount due to the Fund by the end of 1985 together with the present volume of overdue obligations were equivalent to $228 million, or 35 percent of the value of Sudan's exports in 1985. Moreover, annual obligations to the Fund and other multinational institutions over the coming five years would account for about 50 percent of the country's total export proceeds. In those circumstances, the Fund should treat Sudan flexibly. The authorities were clearly making every effort to become current in their obligations to the Fund. Accordingly, the next review of the Executive Board's decision on Sudan should be on September 9, 1985, rather than in August as the staff had suggested. The authorities and donors could use the additional time to discuss possible solutions to the problem of Sudan's overdue financial obligations.

The Director of the Middle Eastern Department explained that the staff intended to visit Sudan from about June 25 to July 10, 1985. If the staff and the authorities reached an understanding on a satisfactory set of policies, the staff would so report to the major donors. If all the arrears were eliminated, the staff could rapidly conclude discussions with the authorities and circulate a further report on Sudan to the Executive Board within six to eight weeks of its return to headquarters.

Mr. Alfidja remarked that the authorities apparently were arranging for the full and prompt settlement of Sudan's overdue obligations that would re-establish normal financial relations between Sudan and the Fund. He was pleased to learn that a Fund mission planned to visit Sudan soon.

The economic and financial problems facing Sudan were severe, Mr. Alfidja commented. The new Government understandably needed more time to study the economic situation and to formulate adequate policies to address the financial problems of the country and, in particular, to settle the overdue obligations. In the circumstances of Sudan, the one-month time span within which the authorities were to formulate and begin to implement appropriate comprehensive adjustment policies was excessively brief. However, the formulation and implementation of those policies clearly should not be postponed any longer. The authorities should accelerate their pace and act decisively.

However, the Executive Board should be flexible and show understanding for the plight of Sudan, Mr. Alfidja concluded.

The staff representative from the Treasurer's Department remarked that, as he understood it, Mr. Mtei wished to hold the next review of the decision concerning Sudan's overdue obligations in three months. The Executive Board's normal practice was to review such decisions within a period of not more than three months; the Board could decide to hold a review in less than three months. The case of Sudan was unusual in that the present review had been postponed for one month in light of recent change in Government in Sudan. In light of the continuing discussions with the authorities, and their efforts to arrange financing, the staff had felt that it might be convenient to review the Sudanese situation again shortly after the return of the next mission to Sudan in July. If it were decided to hold a review on August 9, that would in effect make up for the postponement of the present review, as the August 9 review would be held six months after the decision limiting the use of Fund resources.

Mr. Nimatallah remarked that the problems facing the economy had been due largely to mismanagement by the previous Government. Given the information provided by the staff, the authorities' efforts to receive additional assistance from donor countries, and the difficulty in handling matters during Ramadan, which would last until nearly the end of June, the proposal to wait until August 9 to hold a further discussion on Sudan was acceptable. By then the staff might be able to provide a more detailed report on recent developments in Sudan. He hoped that the report would show that the authorities were formulating a serious program of action to reduce existing large economic and financial imbalances.

Mr. Leonard noted that the decision limiting Sudan's use of the Fund's general resources had been adopted on February 8, 1985. At that time, the Executive Board had agreed to review the decision within three months. The Board had subsequently delayed the review for one month. He wondered whether the staff proposal to review the decision again within a further three-month period was consistent with established practice.

The staff representative from the Treasurer's Department remarked that the experience with respect to the treatment of overdue obligations was based on just three cases. The duration of the first review period for Viet Nam had been three months; at the time of that review, the Executive Board had decided that if Viet Nam still had overdue financial obligations after another six weeks it would become ineligible to use the Fund's general resources. In contrast, for Nicaragua and Guyana the Executive Board had agreed to four reviews of approximately three months each. Accordingly, there had been almost a year between the decision limiting the use of Fund resources by Nicaragua and Guyana and the point at which it had been expected that a decision would be taken to declare those members ineligible in the absence of settlement. The treatment of Viet Nam had been based partly on the fact that Viet Nam had made no payments to the Fund after arrears had arisen. In the case of Sudan, if the review had been held on the originally scheduled date and the Executive Board had agreed to a further review period of three months, the next review would have had to be held no later than August 9, just prior to the scheduled Executive Board recess. It could be argued, however, that the change in Government in Sudan was a legitimate reason for holding the next review of the decision on Sudan on September 9 rather than on August 9.

The Director of the Middle Eastern Department commented that the staff report to the Executive Board soon after the return of the next mission to Sudan would cover the authorities' progress in formulating and implementing adjustment measures. In addition, the staff expected to report on developments to the major donors, who would then make their own assessment of Sudan's situation and decide whether or not to provide resources to enable the authorities to eliminate their overdue financial obligations to the Fund. The staff could not say for certain how much time was likely to lapse between the return of the next mission to headquarters and the elimination of the overdue obligations to the Fund.

Mr. Dallara said that he welcomed the plans to send a staff mission to Sudan in the near future to conduct technical discussions that could provide a framework for evaluating and formulating an appropriate set of economic policies. The authorities should clearly understand the considerable importance that his authorities attached to ensuring that progress was made during those discussions in formulating a comprehensive adjustment program designed to handle the serious problems facing Sudan's economy.

Sudan's arrears to the Fund were a serious matter both for the country and the Fund, Mr. Dallara continued. Sudan's arrears of SDR 120 million represented 45 percent of all arrears to the Fund. Sudan's arrears on interest charges as of June 5, 1985 were SDR 30 million, or 51 percent of the total overdue interest payments to the Fund. Moreover, of the SDR 56 million in the Fund's interest income on a nonaccrual basis during the previous year, SDR 25 million was due to overdue interest payments by Sudan; that nonaccrual of income had been a major factor in the shift from an expected net income for the Fund of SDR 36 million during the previous fiscal year to a deficit of SDR 30 million. The problem of growing arrears to the Fund was one of a number of factors that had recently led the Executive Board to raise the annual target for reserve growth from 3 percent to 5 percent, a decision that had implications for all members.

The authorities should make every effort to eliminate promptly their arrears to the Fund, Mr. Dallara stated. The implementation of an economic adjustment program should be at the heart of that effort. The indication by Mr. Mtei that the authorities were determined to formulate and implement a comprehensive adjustment program and to normalize relations with the Fund was encouraging.

The situation facing the new Sudanese Government was difficult, Mr. Dallara remarked. There were serious imbalances in the economy owing to a variety of factors, especially past inappropriate policies. The authorities should formulate a strong and comprehensive adjustment program based on the full range of possible measures, including supply-side measures designed to restore economic growth and balance of payments sustainability. In addition, the authorities should be expected to give a high priority to using available foreign exchange--including inflows from donors--to meet their overdue obligations to the Fund.

Sudan obviously could not solve all the problems facing its economy alone, and the U.S. authorities were prepared to join others in supporting its efforts, Mr. Dallara said. Indeed, the broad support of the international donor and financial community was required if those efforts were to succeed. To help catalyze that support his authorities were prepared to provide, under certain circumstances, a $50 million deposit that would be used by Sudan to secure a bridge loan of an equivalent amount which, in turn, would be used to repay SDR 50 million in arrears to the Fund. That deposit would be made available by the U.S. authorities once there was clear progress in the Sudanese authorities' technical discussions with the Fund on a comprehensive adjustment program and once agreement had been reached on an overall plan, including support by other donors, to eliminate Sudan's arrears to the Fund. It would of course be important for the donor community not only to help eliminate the arrears but also to support the broader effort to close any balance of payments financing gap at the time a new program was formulated. Accordingly, the Sudanese authorities' firm commitment from Arab donors was encouraging. U.S. support would not contribute to achieving the basic objectives of restoring Sudan's economic vitality and good standing in the international financial community unless the domestic policy actions and donor support were broad based.

In light of the various factors that had been discussed, including the authorities' intention to move ahead promptly to formulate and implement appropriate economic policies, and the need to mobilize donor support as soon as possible while remaining consistent with the Fund's established practices, August 9 was an appropriate date for the next review of the decision concerning Sudan's overdue obligations to the Fund, Mr. Dallara concluded. He looked forward to reviewing the results of the coming technical discussions between the staff and the authorities.

Mr. Finaish remarked that the situation in Sudan obviously was difficult and serious. The problems facing the economy were not due solely to mismanagement; external factors also had played an important role. Sudan had suffered from an extended drought and clearly required substantial assistance from the international community. It was true that the new Government needed some time to assess the economic situation and seemed to be doing its best to handle the problems facing the economy. Moreover, the authorities had collaborated closely with the Fund in dealing not only with the arrears but also with the need for adjustment policies in the coming period. In the circumstances, Mr. Mtei's proposal to hold the next review on September 9, 1985 was acceptable. Holding the review one month later than the staff had suggested should not present a significant problem. As the staff had stressed, it would need sufficient time to visit Sudan and report to donors.

Mr. Leonard considered that the case of Sudan was particularly difficult. In handling it the Fund ran the danger of treating members in arrears inconsistently. The date of the finding that a member was in arrears was a particularly significant development in the series of events in the Fund's handling of the member. In most instances, the Fund had responded promptly to the finding that a member was in arrears. For example, Nicaragua and Guyana had been given three months to eliminate their overdue obligations to the Fund; the authorities had been clearly informed that a formal decision on the arrears would be taken at the end of the three-month period. As he understood it, the staff was not proposing to treat Sudan in precisely the same manner. There were admittedly exceptional circumstances in the case of Sudan: a new Government had recently taken office; and the economic situation was unusually difficult. The Executive Board should certainly bear those facts in mind and respond with a degree of flexibility. But it was important to remember that there were two sets of issues in the case of Sudan, namely, the need for longer-term economic adjustment, and the need to eliminate the arrears to the Fund in the short run. Short-term assistance from the United States and other sources was unlikely to be available unless the Sudanese authorities fulfilled a number of conditions. If the conditions were not met and the short-term aid Sudan needed to eliminate its arrears was not forthcoming, and if the Fund had permitted Sudan a relatively long period in which to eliminate its arrears, the Fund might well appear to be inconsistent in its treatment of members in arrears. Much would depend on the speed at which the short-term assistance could be provided. The period that Sudan would be given to eliminate its arrears should not be stretched beyond August 1985.

Mr. Nimatallah said that he favored holding the next discussion on Sudan on August 9, 1985 in order to maintain the Fund's evenhanded approach to all members in arrears. Moreover, agreement on that date would reflect the Fund's appreciation both of the need for the new Government to assess the situation and of the fact that administrative activities generally slow down during Ramadan.

The staff representative from the Treasurer's Department recalled that the complaint against Guyana had first been considered by the Executive Board in June 1984, when a decision limiting Guyana's use of the Fund's resources had been taken. Thereafter, the Executive Board had reviewed its decision on Guyana on four occasions, at intervals of approximately three months. Guyana had been declared ineligible to use the Fund's general resources in mid-May 1985, approximately 11 1/2 months after the Executive Board had first considered the complaint.

The treatment of Nicaragua had been similar, the staff representative went on. Approximately 11 months had elapsed between the initial consideration of the complaint against Nicaragua and the date on which the country might have been declared ineligible to use the Fund's general resources. In fact, Nicaragua had become current in its obligations to the Fund shortly before a declaration of ineligibility was to have been discussed by the Executive Board. Viet Nam's overdue obligations had been initially considered by the Executive Board at the end of August 1984, and Viet Nam had been declared ineligible to use the Fund's resources with effect from mid-January 1985. In handling each of the three cases the Executive Board had responded to the particular circumstances of the country concerned.

The complaint against Sudan had been considered by the Executive Board on February 8, 1985, the staff representative from the Treasurer's Department continued. A further review on August 9, 1985 would mean that six months would have elapsed between the decision on the complaint and the second review of that decision. In considering previous cases Executive Directors had attached importance to the country's record of payment to the Fund. Sudan had paid SDR 35.5 million to the Fund since the Managing Director's complaint had been circulated to the Executive Board.

Mr. Clark said that as a general rule the Executive Board should review cases of overdue obligations whenever it seemed useful to do so and in any case at intervals no longer than three months. It would certainly be useful to receive a report from the staff mission soon after its return to headquarters, say, in early August. Although Sudan had made repayments to the Fund in recent months, the total amount of its arrears had increased substantially.

Agreement on future reviews of members in arrears to the Fund should not be mechanical; it should be based on a clear understanding of the steps that were to be taken by the time of the next review, Mr. Clark continued. There were signs that the Sudanese authorities were taking steps to bring the economic situation under control in particularly difficult circumstances. He had no difficulty, therefore, in approving the proposal to hold a further review. Agreement on a slightly longer or shorter review period should not be interpreted as implying greater or lesser favor by the Executive Board. The main purpose of any review was to assess a member's current situation. If there were no signs that a member in arrears was going to take convincing steps in coming months, the Executive Board should be reluctant to agree to an additional review merely to conform with past scheduling in other cases.

Mr. Castellanos remarked that the problem of Sudan's overdue obligations was complex. The amount of arrears was substantial, and the prospects for their prompt settlement were unfavorable in light of the projected weak performance of the external sector and the absence of a comprehensive medium-term program of corrective measures. The authorities needed to adopt a package of strong adjustment measures to tackle the increasing imbalances in the economy, especially in the external sector. The new Government's commitment to solve the problems facing the economy was welcome.

As he understood it, the review of the decision concerning Sudan's overdue obligations had been postponed to give the authorities sufficient time to prepare a comprehensive adjustment program, Mr. Castellanos continued. The delay in the preparation of the program was a cause for concern, as full settlement of Sudan's outstanding obligations was unlikely in the absence of such a program. The decision concerning Sudan's overdue obligations should be reviewed no later than August 9, 1985. That approach would give the authorities sufficient time to implement the needed corrective measures.

Mr. Chen said that he agreed with Mr. Mtei's proposal to conduct the next review in September 1985. The economic situation in Sudan was unusual, and the Executive Board should respond to it in a flexible manner. Moreover, the authorities had shown that they were strongly committed to achieving economic adjustment and to normalizing Sudan's relations with the Fund. Indeed, steps in that direction had already been taken. Mr. Mtei's proposal was consistent with the likely timetable for the negotiation of a Fund-supported program.

Mr. de Groote stated that the measures the authorities had been taking were clearly in the right direction. He strongly supported the proposal to hold the next review within two months of the date of the approval of the draft decision.

Mr. Alfidja said that his position was the same as that of Mr. Mtei.

Mr. Polak remarked that the Sudanese authorities, unlike the authorities of some other members, were clearly taking significant steps to deal with their overdue obligations to the Fund. Some time was needed to determine the effect of the new measures, but it seemed best to take another look at the situation in Sudan as soon as additional information became available; that information would undoubtedly affect Executive Directors' attitude toward Sudan's case. Accordingly, the next review should take place in two months.

Mr. Grosche said that he agreed that the Executive Board should take another look at the situation in Sudan as soon as additional information became available. Accordingly, the next review should be held in two months.

Mr. Rye commented that he too favored holding the next review on August 9, 1985. There seemed to be some forward momentum in the case of Sudan and the Fund should therefore be reasonably flexible, but an agreement to hold the next review in September 1985 would provide for an excessively long period between reviews and would send the wrong signal. Presumably the Executive Board would eventually have to declare formally Sudan ineligible to use the Fund's resources unless the country became current in its obligations to the Fund. It was clearly too early to take that step, but the fact that such a step might eventually have to be taken was a good reason to hold the next review within two months, rather than three months.

Mr. Fugmann and Mr. Coumbis said that their position was the same as that of Mr. Polak and Mr. Clark.

Mr. Blandin considered that the most efficient and appropriate solution was to hold the next review on August 9, 1985.

The Director of the Middle Eastern Department, responding to a question by Mr. Vasudevan, said that there was no way of knowing for certain how much time Sudan would need to gain a position in which it could discharge its arrears to the Fund. Assuming that the authorities would be able to eliminate the arrears soon after the donors were advised that Sudan had made sufficient progress in implementing appropriate adjustment measures, the staff might well be able to circulate a request for a stand-by arrangement in six to eight weeks after its return from Sudan on about July 10.

Mr. Vasudevan remarked that in the circumstances it seemed best to give the staff and the authorities more than just two months before the next review of the decision concerning Sudan's overdue obligations. Mr. Mtei's proposal to hold the review on September 9, 1985 was acceptable.

The Executive Board then took the following decision:

1. The Fund has reviewed Decision No. 7903-(85/20), February 8, 1985 in light of the facts described in EBS/85/114 (5/2/85) and EBS/85/114, Supplement 2 (6/7/85), pertaining to Sudan's overdue financial obligations to the Fund.

2. The Fund welcomes the partial payments that have been made by Sudan. However, the Fund regrets the continuing non-observance by Sudan of its financial obligations to the Fund and notes that further substantial obligations will fall due in the

near future. The Fund urges the Sudanese authorities to make full and prompt settlement of the overdue financial obligations to the Fund.

3. The Fund calls upon Sudan to adopt urgently a strong and comprehensive program that would bring about a much needed economic adjustment.

4. The Fund shall again review Decision No. 7903-(85/20) not later than August 9, 1985.

Decision No. 8002-(85/93), adopted
June 10, 1985

2. NEW ZEALAND - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with New Zealand (SM/85/139, 5/14/85). They also had before them a report on recent economic developments in New Zealand (SM/85/145, 5/21/85).

Mr. Derek Gill, The Treasury, New Zealand, was also present at the discussion.

Mr. Rye made the following statement:

My New Zealand authorities regard the staff report, and its companion report on recent economic developments, as of a particularly high standard. These documents provide a comprehensive and balanced description of the far-reaching economic reforms and associated developments that have occurred in New Zealand since the last consultation with the Fund. My authorities wish to thank the staff for these useful reports. They also wish to acknowledge with gratitude the technical assistance the Fund has provided on the proposed goods and services tax.

The New Zealand Government's economic reforms conform very closely with the approach that the Fund has advocated in recent consultations. Accordingly, there is no need to dwell on the specific policy changes that have been, or are being, implemented. Rather, I should like to make some general points which may help Executive Directors better appreciate the framework within which that strategy was conceived. I shall also address the "tactical and timing" issues raised by the staff in relation to the implementation of the strategy.

The key recent economic developments have been:

- strong indications that the government budget deficit for the current (1985/86) fiscal year will be much less than

NZ$2,200 million (5 1/4 percent of GDP), the figure for 1985/86 in the Treasury's medium-term fiscal projections. The fiscal deficit as a proportion of GDP could well be reduced to the level considered broadly acceptable by the New Zealand authorities--around 2 percent of GDP--more quickly than previously envisaged;

- a marked slowing in the rate of growth in the monetary aggregates in the March quarter 1985. M-3 (seasonally adjusted) increased by only 0.6 percent, and the corresponding movement in M-1 was a fall of 9.2 percent--although this fall reflects in part technical factors and a shift out of noninterest bearing M-1 balances following the removal of controls on interest rates for short-term bank deposits. Lending growth by financial institutions, on the other hand, remained strong (5.9 percent) in the March quarter, reflecting a continuing buoyant level of economic activity, although financial deregulation has probably inflated the figures;

- yields on government bonds in the most recent tender (May 16) rose to average 21.8 percent for 2 years, 20.4 percent for 5 1/2 years, and 19.2 percent for 10 years. Subsequently, however, secondary market yields have begun to ease in response to the expected cut in the government deficit;

- from February 1984 to February 1985 employment increased by 45,600 persons and in the year to April the registered unemployed fell by 17,000 to 48,900 (about 4 percent of the work force);

- real GDP for 1985/86 is now expected to be up to 2 percent above its 1984/85 level, compared with growth of less than 1 percent expected at the time of the mission. This revised projection reflects continued growth in net exports and in investment, offset to some extent by a fall in real consumption. The surprising strength of investment in the face of a slowdown in the rate of growth in real GDP reflects in part a more optimistic medium-term outlook, which is becoming clearly evident in surveys of business opinion and investment intentions;

- the external current account deficit in 1985/86 is now expected to be about NZ$2.1 billion, up from about NZ$1.2 billion forecast at the time of the mission. The revision can be attributed about equally to a less favorable outlook for the terms of trade, particularly for dairy exports, and to increased imports for investment purposes (including new aircraft for Air New Zealand, and some carry-over of major project imports from 1984/85).

Two general points should be borne in mind. First, while the program of economic adjustment on which New Zealand has embarked has as an important objective a substantial easing in the large macroeconomic imbalances of recent years (particularly in the government and external accounts), the authorities have also been paying considerable attention to the need to enhance flexibility and efficiency in the economy at the micro-level. A key consideration has been to provide appropriate price signals and incentives. Thus, measures to improve the fiscal position have included the removal of export subsidies and increases in the prices charged for publicly provided goods and services so that they bear a closer relationship to resource costs. The decision to float the exchange rate was motivated by a conviction that any other regime would be less capable of signaling changes in relative prices in a timely way as well as by the realization that a float can facilitate more effective monetary control. And deregulation of the financial system, which was necessary to make monetary policy effective, also reflects a view that a competitive and responsive financial system is vital for the efficient allocation of investment resources.

Second, there has been a high level of consultation between the authorities and the affected sectors and various interest groups. Shortly after taking office, the Government called a national economic summit, at which a broad measure of consensus for a change in direction was achieved. This consultative approach has been extended to wage determination procedures, where tripartite discussions among the social partners have been instituted as a formal part of the wage negotiation processes. The aim is to ensure that the economic situation is taken sufficiently into account when wage claims are being struck and settlements made. Reform of the income tax and social welfare benefit systems is also a matter on which the public is being widely consulted, by a task force established specifically for that purpose. More generally, the Government is actively consulting with affected parties day by day; and it is making available more economic information, including medium-term fiscal projections, as a means of promoting public discussion and understanding.

As to tactics and timing, the question might be put whether New Zealand has attempted too much too quickly. My own view is that it can be convincingly argued that a more selective approach would have made the adjustment process more, not less, difficult. To have moved in some areas but not in others would have intensified existing distortions and inefficiencies in those areas not addressed. Most obviously, it would not have been possible to phase out export incentives without first, restoring exchange rate competitiveness, and second, moving to relieve the export sector from the additional costs it carries from the protection afforded the domestic economy through regulation and protection from imports. In the area of financial deregulation, no satisfactory "halfway house" could be found. The move to market-based government funding techniques rendered the compulsory government security investment requirements both anomalous and redundant and, given that they could only inhibit adjustment in the financial sector, they were best removed. As for interest rates, it had become evident to the authorities that attempts at regulation in only part of a financial market quickly become futile, if not counterproductive.

The foregoing also explains in part why the authorities moved so quickly. Once the process of adjustment was set in train, the need for early complementary actions became quickly obvious. Moreover, the magnitude of the imbalances which had emerged limited the room for maneuver and called for decisive action to arrest, and then reverse, the underlying trends. By acting decisively, moreover, the Government has been able to influence public attitudes and expectations in a way which might not otherwise have been possible. More specifically, a speedy attack on the budget deficit was called for to enable some easing of the very heavy pressures it has been placing on monetary policy.

It should be recognized that some strands of the policies being pursued by the new Government were already being implemented when it came to office. Industry restructuring and associated external protection reform through industry development plans had been under way for some time. Also, progress had already been made in deregulating the transport industry, retail trading (through an extension of shop trading hours), and the meat-freezing industry. Additional competition had been introduced into the foreign exchange market through a considerable expansion in the number of approved foreign exchange dealers. Certainly the new Government has approached economic reform on a wider front and has accelerated the process, but it is possible to overstate the extent of the change.

Let me finally turn to what my authorities take as the main specific concern of the staff--the possibility, mentioned on page 19 of SM/85/139, that "the acceleration in the rate of inflation during the period to mid-1985 might spark off excessive wage claims in the wage round commencing in October...[and that] in such an environment, the impending goods and services tax might accelerate the momentum of inflation by feeding through into a further round of wage increases." My authorities agree that this is potentially a major source of concern. They are addressing it as follows:

- through the tripartite discussions;

- by giving an assurance that the net revenue raised by the new goods and services tax will be used to reduce income taxes and enhance and restructure welfare benefits. Particular attention will be given to low-income earners;

- through the maintenance of firm financial policies. The Government has made it absolutely clear that it will not waver on this, as demonstrated by its readiness to accept the high rates of interest currently prevailing. In essence, the Government has established a nominal income objective, and is making clear to the social partners that the greater the extent to which this is taken up in inflation, the more severe will be the adverse consequences for output and employment.

In sum, the strategy that has been adopted by New Zealand comprises three elements: a balanced program, decisive action, and community understanding. I believe that this strategy is courageous, enlightened, and well founded.

Mr. Wijnholds noted that for many years the economy had performed poorly owing partly to unfavorable external conditions and partly to inadequate economic policies. That that situation had continued for such a long time was a reflection of New Zealand's good standing in the international financial markets. However, a large external debt had been accumulated, external competitiveness had been eroded, and sizable imbalances in the domestic economy had been allowed to develop. The Government that had taken office in 1984 had implemented an impressive series of policies and had achieved considerable success, but some areas of the economy remained in danger. Still, he fully agreed with the staff that the authorities' present policy course was courageous and enlightened.

The authorities were to be strongly commended for their determined market-oriented approach and for framing their policies in a medium-term perspective, Mr. Wijnholds considered. A large number of policy measures had been adopted; indeed, in his opening statement Mr. Rye had appropriately addressed the question whether the authorities had not attempted too much too quickly. He fully agreed with Mr. Rye that the authorities' comprehensive approach had been required in order to avoid increasing the distortions in the areas of the economy that were not subject to immediate reform. A number of countries that were moving toward a market-oriented economy were deliberately doing so gradually because of internal factors. The New Zealand authorities should maintain their forward momentum and implement additional measures to liberalize trade and improve public enterprises as soon as possible.

Given the medium-term framework of the authorities' policies, assessments of their performance should not focus unduly on short-term developments, Mr. Wijnholds continued. The increased rate of inflation was obviously due to the suppression of inflation over a long period by the previous Government, and a deceleration to the normal rate of about 8 percent was projected to take place by early 1986. To that end, firm demand management policies and continued wage moderation would be needed. Trade liberalization would also help in the fight against inflation, and the proposed phased reduction of the current high tariffs was welcome. That the improvement in the external current account in 1985/86 was much smaller than had originally been expected was not a cause for concern. A further comment on the outlook for trade and on the effect of the increase in the projected current account deficit for 1985/86 on the medium-term debt scenario would be helpful.

The recent considerable reduction in the budget deficit and the further expected decline to 2 percent of GDP were commendable, Mr. Wijnholds said. The authorities had shifted their emphasis from increasing revenues to containing expenditures. Accordingly, they intended to reduce subsidies, contain welfare spending, and encourage cost recovery by public enterprises. Such moves were needed in light of the significant increase in the cost of servicing the public debt. The authorities had sensibly decided to reform the social welfare system and to introduce a goods and services tax to compensate for revenue losses due to the reduction of the income tax, the revenues from which had constituted a large proportion of total revenues. However, the effect of the new goods and services tax on wages could fuel inflation. He hoped that the authorities could limit that effect and avoid a wage-price spiral. In that connection, the staff and Mr. Rye had appropriately stressed the need to maintain firm financial policies. There also seemed to be scope for an incomes policy based on a consensus among the relevant groups.

There was considerable uncertainty about the definition of appropriate monetary aggregates in New Zealand, Mr. Wijnholds remarked. That problem often arose during periods of financial deregulation, and, in the circumstances, the authorities' decision not to adopt quantitative monetary targets was understandable. However, that decision would not be appropriate indefinitely. The authorities should search for a monetary benchmark--which need not be a full-fledged monetary target--to give them an indication of the degree of success of monetary policy when the distorting effects of deregulation on the aggregates had largely worn off. The decision to float the exchange rate had given the authorities increased freedom in the conduct of monetary policy and care should be taken to use that freedom prudently. The high short-term interest rates and the recent movement of the monetary aggregates suggested that the authorities had maintained firm monetary control. In any event, the authorities' policy of avoiding monetary financing of the budget deficit and the shift in emphasis in the placement of bonds away from retail sales of fairly liquid paper and toward institutional investors were welcome.

The debt situation inherited by the new Government was obviously an unhealthy one, Mr. Wijnholds commented. Although manageable, the debt service would increase in the near future and would rise again after 1988/89. The authorities' intention to repay official external debt when unwanted upward pressure on the exchange rate occurred seemed reasonable.

However, that policy would entail intervention in the foreign exchange market, which seemed inconsistent with the authorities' intention of maintaining "as clean a float as possible." That conclusion was not a cause for concern; in some respects managed floating was beneficial, especially for small open economies.

Mr. Ismael said that there had been several positive developments since the previous consultation with New Zealand (EBM/84/37 and EBM/84/38, 3/9/84), although a number of weak spots in the economy remained. The policies of the new Government were broadly in line with the recommendations of the staff and the Executive Board. It was difficult to forecast likely developments in the economy over the coming several years, particularly in light of the dramatic policy changes that had already been made and that the authorities planned to make in the near future.

Recent economic developments had been mixed, Mr. Ismael continued. In 1983/84 real GDP had increased by 4 percent--after a small decline in 1982/83--the rate of inflation had fallen to 5.1 percent, real unit labor costs had been reduced, and the rate of unemployment had declined. However, the budget deficit had increased to the equivalent of 9 percent of GDP, and lax monetary policy had caused M-3 to increase at an annual rate of 18 1/2 percent at the end of 1984 and 16 percent in February 1985. The balance of payments had weakened in 1983/84, and external reserves had declined to the equivalent of 1 1/2 months of imports. By March 1985 reserves had fallen to approximately one month of imports.

The authorities had made a number of policy changes in response to the negative economic developments, Mr. Ismael remarked. Those measures were in the right direction, the pace of policy change was appropriate, and the measures should go a long way toward correcting imbalances in the economy.

The measures aimed at reducing the fiscal deficit from 9 percent of GDP in 1983/84 to 7 percent in 1984/85 were welcome, Mr. Ismael said. The fiscal performance in 1985/86 was likely to be much better than had initially been expected, and the authorities had a good chance of achieving their medium-term fiscal objectives. Nevertheless, further progress in reducing the budget deficit was necessary if economic growth together with price and external stability were to be achieved.

The liberalization of interest rates and the removal of certain financial restrictions were also welcome, Mr. Ismael went on. It was difficult to set monetary targets when a major deregulation of the monetary system was occurring, but the rate of monetary expansion should be monitored closely; the achievement of noninflationary growth would be difficult in the absence of firm control over monetary growth. The rate of growth of the monetary aggregates had slowed in the first quarter of 1985, but the annual rate of inflation in March 1985 had exceeded 13 percent. In the absence of sufficiently tight financial policies, the wage-price spiral that had been endemic to New Zealand in the past might recur.

The recently introduced external policies were in the right direction, Mr. Ismael considered. The 20 percent devaluation in July 1984 had restored export competitiveness, and the authorities had appropriately decided to float the exchange rate, phase out export subsidies, relax import licensing, and reduce the level of protection for domestic industries. However, the import liberalization effort should be more ambitious. He was pleased that the authorities intended to extend the Generalized System of Preferences to 36 least-developed countries, and he wondered precisely when that step would be taken.

Sustained noninflationary growth and a satisfactory balance of payments position could be achieved only if the budget deficit was further reduced to a more sustainable level, monetary policy was further tightened in the short run to eliminate the strong inflationary expectations, the wage moderation of the previous few years was maintained, and the opening of the economy to foreign competition was accelerated, Mr. Ismael concluded.

Mr. Goos said that he agreed with the staff that the authorities had made a "dramatic and welcome" reorientation in economic policy in 1984. That change had certainly been long overdue, given the obvious failure of previous interventionist policies as reflected in the large and growing domestic and external imbalances, the rapidly rising foreign debt, and the downgrading of New Zealand's international credit rating from AAA to AA in October 1984. The thrust of the new Government's policy reforms was consistent with the recommendations by the staff and the Executive Board.

The Government's main task was to preserve the competitive edge that New Zealand had gained as a result of the recent devaluation, Mr. Goos went on. That task was particularly difficult because of the acceleration in the rate of inflation and the risk that wage claims would become excessive. The pent-up wage pressure owing to the wage freeze would certainly be intensified by the new goods and services tax. In the circumstances, the staff's recommendation that the authorities should remain firm and use their persuasive powers to secure moderate wage settlements was well taken. Furthermore, the authorities intended to encourage wage moderation by reducing personal income taxes, but he doubted whether that approach would be effective. The authorities had yet to establish the credibility of their financial policies, although he felt quite encouraged in that respect by Mr. Rye's opening statement indicating the Government's firmness in putting its nominal income objective. More important, other countries that had tried to contain wage pressures by reducing direct taxes while increasing indirect taxes had had little success. Accordingly, he wondered whether the present stabilization strategy should not be complemented by the adoption of additional measures. For example, a more gradual implementation of the tax reform than the authorities planned could reduce its inflationary impact. Another, perhaps more promising measure would be an acceleration of the tariff reform; given the high level of tariffs, the reform offered considerable potential for reducing domestic price pressures. Stepping up the tariff reform was the obvious choice, considering its beneficial effect on the efficiency of resource allocation, and the protection provided by tariffs had probably become largely redundant following the devaluation. He invited the staff or Mr. Rye to comment.

The authorities' flexible exchange rate policy was welcome, but the staff's statement on page 20 of SM/85/139 that "domestic financial policies will still need to be framed with one eye on the exchange rate" was puzzling, Mr. Goos remarked. He wondered whether the staff had meant to imply that after some time the authorities could close both eyes to the rate; that approach would obviously be inconsistent with established Fund policies concerning members' obligations regarding their exchange arrangements. The staff had given a similar impression in stating in the same paragraph that "the possibility of repaying official external debt offers a convenient way of offsetting any unwanted upward pressure on the [exchange] rate." The reference to "unwanted upward pressure" seemed inconsistent with the authorities' objective of maintaining as clean a float as possible. The staff's comment could easily be taken as an invitation to the authorities to intervene in the exchange market whenever they wished to do so, something that would be inconsistent with the Fund's approach toward the proper conduct of exchange rate policy.

Mr. Clark said that the dramatic change in the direction of economic policy was welcome. The authorities' decision to apply more market-oriented policies to replace the wide range of controls and to do so in a medium-term perspective was entirely appropriate. One of the main tasks facing the authorities was to reduce the distortions and pressures in the economy without jeopardizing the success of the new strategy. That task was likely to be particularly difficult if economic growth were to slow temporarily in the coming period.

He agreed with the staff that the results of the October 1985 pay round would be crucial, Mr. Clark continued. In the longer run, the public sector deficit would have to be reduced substantially. Although the deficit in 1985 was slightly smaller than the deficit in 1984, it was substantial. The authorities' commitment to make progressive reductions in the deficit over the coming three years was encouraging. They had already adopted a number of important measures to cut expenditures, and Mr. Rye had indicated that the fiscal outcome in 1985 might well be more favorable than had been expected.

The present high rate of inflation of 15 percent was a reflection of the devaluation and the relaxation of price controls, Mr. Clark remarked. The rate was projected to decline in the coming period, but it would remain high. The behavior of inflationary expectations over the coming several months would be an important factor in the coming wage round. The authorities must be seen to be maintaining firm financial policies, especially in the monetary area. The introduction of a general sales tax together with income tax cuts would have to be handled carefully if an intensification of wage pressures was to be avoided. The authorities would have to show clearly the benefits of the tradeoff between the introduction of a general sales tax and the cut in income taxes.

He wondered whether the authorities had taken any special steps to strengthen the supervision of financial institutions in the wake of the financial deregulation, Mr. Clark commented.

The decision to float the New Zealand dollar was welcome, Mr. Clark said. However, New Zealand remained particularly vulnerable to volatile capital flows because of its relatively thin financial markets. The authorities should provide timely and relevant economic information to enable the financial markets to read signals correctly.

The authorities' trade liberalization program was welcome, Mr. Clark continued.

The staff's medium-term projections suggested that a continuous decline in the ratio of debt to GDP--albeit with some increase in the debt service ratio apparently reflecting a rather unfavorable debt structure--should be possible over the remainder of the 1980s, provided that the external current account deficit could be reduced to around 2 percent of GDP, Mr. Clark noted. The staff's sensitivity analysis showed that that outcome was critically dependent upon export growth: if exports grew more slowly than the staff expected, the ratio of debt to GDP would be correspondingly higher. That conclusion underscored the need to maintain external competitiveness.

The authorities had made a courageous and welcome break with past economic policies, Mr. Clark concluded. There might well be some difficult years ahead until the results of the new policies became evident, but the authorities should persist in their efforts.

Mr. Leonard commented that the authorities had made a courageous and far-reaching shift in economic policy in 1984. A number of benefits of that approach had already become apparent, but the medium-term objectives were of much greater significance than the short-term outcome. The thrust of the authorities' approach was fully appropriate, and the authorities should persevere in their efforts until their restructuring objectives were achieved. The various structural objectives and the range of policy measures to achieve them were mutually consistent and held the promise of being highly effective.

The authorities were attempting to reduce the large fiscal deficit, Mr. Leonard said. In so doing they had wisely decided to rely mainly on expenditure restraint while safeguarding the interests of those who genuinely needed help through the many social assistance programs. On the revenue side, the heavy reliance on direct taxation together with the enlargement of the direct tax base had resulted in high marginal tax rates that had considerable disincentive effects. The steps already taken to reduce tax expenditures were appropriate; the introduction in 1986 of a goods and services tax should enable the authorities to reduce direct personal taxation. For some time corporate profits had been rising strongly largely because of the reduction in real wages. At the same time, personal income tax revenue had been increasing as a proportion of total revenues while the contribution of corporate taxation had been declining. Hence, a case could be made for increasing corporate taxes as a part of the reform of the tax system, and he wondered whether any such change was contemplated.

If the social consensus the authorities were seeking in support of their economic strategy did not materialize, the burden of the task of maintaining balance in the economy would fall on monetary policy, Mr. Leonard remarked. The liberalization of the financial markets--particularly the deregulation of interest rates--was welcome. The authorities had decided that in the short run the new conditions in the financial markets would reduce the usefulness of conventional monetary aggregates as indicators of monetary conditions and that monetary targets should not be set. That decision was understandable, but he agreed with the staff that as long as inflationary expectations remained substantial the authorities must use other means to ensure that market participants remained fully aware of the anti-inflationary stance of monetary policy.

Maintaining a consensus among the social partners--including the trade unions--seemed crucial for the success of the effort to contain inflation and to achieve the Government's medium-term goals, Mr. Leonard said. A further comment on the circumstances in which such an accord was likely to succeed would be helpful. Could such an accord realistically be expected to last for more than a brief period? There might well be a danger that trade union pressure for significant nominal pay increases would increase after the direct tax reform, especially if prices were rising and unemployment were falling.

Mr. Nimatallah commented that there had been a remarkable change in New Zealand's economic and financial policies since the previous Article IV consultation. Mr. Rye had correctly called the new approach courageous, enlightened, and well founded. The previous, gradual approach to adjustment had not worked; indeed, it had added to the structural imbalances in the economy. Moreover, the new approach was based on a realistic assessment of current problems, which required swift and comprehensive remedies. The decisive manner in which the authorities had acted had already done much to restore domestic and external confidence. Furthermore, the new approach was market-oriented, outward-looking, and was based on a coordinated set of policies that focused on short- and medium-term objectives, thereby paving the way for sustained growth. The experience of 1974-79 showed that such a strategy could promote external adjustment. The reliance under the new approach on consultation between the Government and the social partners should help to create the necessary consensus in support of the reform program. Given the difficult tasks facing the authorities, such a consensus was vital.

In the short run the authorities should maintain firm financial policies to reduce both the rate of inflation and the external deficit, Mr. Nimatallah continued. The authorities' commitment to reduce the budget deficit significantly over the coming three years was welcome. The measures they had implemented to restrain current expenditure were fully appropriate, and their determination to phase out costly subsidies and to streamline welfare benefits were appropriate and courageous. Their intention to maintain their effort to place the public enterprises on a sounder footing was welcome, particularly in view of the enterprises' importance in the economy. The introduction of a goods and services tax should not only broaden the tax base but also provide much-needed room in which to simplify the tax system.

The fiscal restraint should facilitate monetary management, Mr. Nimatallah remarked. The abolition of monetary controls and the introduction of new monetary policy techniques had increased the difficulty in monetary management in the short run. The deregulation of the financial system should help to make monetary policy more effective over time.

The firm financial policies must be supported by wage restraint, Mr. Nimatallah considered. The authorities' entire strategy could be undermined by excessive settlements in the coming wage round. The authorities fully understood that danger, and they should continue their efforts to reduce the long-standing rigidities in the labor market. Linking wage compensation more closely to productivity would be particularly important, partly because it could help to create employment opportunities in the medium term.

The authorities' steps to dismantle the complex and costly system of export incentives and import restrictions were commendable, Mr. Nimatallah said. The process of trade liberalization should be maintained in the coming period.

Mr. de Groote considered that the authorities were to be commended for the strategy adopted in 1984 to cope with the growing internal imbalances. The monetary and fiscal policies maintained during the long wage and price freeze had poorly prepared the economy to withstand the pressures that had arisen in the period after the freeze. The increasing fiscal and external deficits could have easily rekindled inflation if the authorities had failed to act promptly and vigorously in 1984.

The Government's strategy was based mainly on market-oriented management and was focused on achieving medium-term objectives, Mr. de Groote noted. The strategy was particularly suitable to New Zealand's open economy, and the implementation of measures under the strategy had already made important changes in the economic environment. New Zealand was a good example of the ability of economic agents to adapt to adjustment measures introduced rapidly and with determination. The authorities should ensure that the various economic agents and institutions clearly understood that the adjustment strategy would be maintained in the coming period. To that end, the authorities must continue both to focus the adjustment strategy on the medium term and to seek improvement in several major policy areas simultaneously.

Fiscal policy would play the major role in achieving a balanced overall economic performance, Mr. de Groote considered. The authorities had appropriately decided to reduce the total fiscal deficit from 9 percent of GDP to 2 percent over the medium term. He agreed with the staff that that objective should be achieved mainly through expenditure restraint and an expansion of the income base. The present tax structure depended mainly on direct taxation, and there was clearly room in which to increase the role of indirect taxation, which should tend to restrain consumption and stimulate saving. The authorities had wisely decided to introduce a goods and services tax.

He strongly supported the measures aimed at improving the efficiency of both the financial system and monetary policy, Mr. de Groote said. The authorities were determined to maintain a firm monetary policy, but that objective would not be easy to achieve in the absence of quantitative targets. The relationship between primary liquidity and broad money in New Zealand was not clearly understood. Short-term money management had become somewhat difficult and risky, particularly as the adjustment effort was in an early stage. In February 1985, M-3 had increased significantly and the expansion of credit to the private sector had been excessive. Indeed, the growth in lending had been substantial throughout the first quarter of 1985. In the coming period monetary policy should be designed to support the adjustment effort.

The sizable devaluation in 1984 and the adoption of a floating exchange rate system in 1985 had increased competitiveness and paved the way for a new, more market-oriented development strategy, Mr. de Groote noted. He agreed with the staff that the authorities should have exchange rate developments in mind when they formulated their domestic financial policies. In light of the medium-term projections for external debt and debt service, the objectives concerning the competitive position and the transfer of resources were of key importance and should be pursued vigorously. In the medium term an improvement in the competitive position would not be possible in the absence of a transfer of resources to the balance of payments. Once stability in the exchange rate was achieved, the authorities would have to rely on other policy instruments--particularly an active incomes policy--to maintain competitiveness and encourage a gradual transfer of resources together with gradual reductions in the fiscal deficit. Wage policy would therefore be of vital importance for achieving a sustained recovery. The staff reports contained an extensive discussion of competitiveness, but a further comment on the profitability of enterprises, especially manufacturing firms, would be helpful. An analysis of sectoral financial balances would provide useful insights into the competitiveness of the economy.

Mrs. Walker said that she was pleased that the authorities had made a dramatic shift away from policies of frequent and widespread government intervention in the economy and toward a more market-oriented approach. The shift in strategy had been followed promptly by strong actions: the devaluation and floating of the New Zealand dollar; the virtual elimination of exchange controls; the introduction of a new wage settlement system;

the taking of first steps toward dismantling import restrictions and artificial export supports; the decontrol of interest rates and implementation of other financial market reforms; the initiation of a major tax reform.

To ensure more efficient resource allocation under the new strategy, correct price signals would have to be sent throughout the economy, particularly with respect to the cost of foreign exchange, labor, capital, and publicly produced goods and services, Mrs. Walker continued. Recent developments in all those areas were positive. The movement of the real effective exchange rate since mid-1984 and of relative unit costs since 1981 suggested that the competitive position had been considerably strengthened. The fall in real wages in 1984, the likely further drop in 1985, and the decline in unit labor costs in 1984 should improve the chances of achieving continued employment growth. The rise in nominal and real interest rates following their decontrol in 1984 had made the cost of capital more realistic and should encourage saving and more efficient investment. Moreover, the major adjustments in administered prices on April 1, 1985 should help to correct previously inappropriate relative prices.

The next round of wage negotiations, in October 1985, posed the greatest threat to the new strategy, Mrs. Walker remarked. The termination of price controls, the impact of the depreciation of the exchange rate, and the recent adjustments in administered prices would probably be reflected in a temporary acceleration in the rate of inflation in 1985. As a result, real wages were likely to decline in coming months, thereby creating pressure for labor unions to seek large catch-up wage increases. In addition, inflationary expectations were likely to remain high despite the authorities' firmer financial policy stance. However, in light of the new wage settlement system, the consultations among the social partners, and the possible tax cuts and continuation of social welfare benefits to protect lower-income groups, the authorities should be in a position to avoid excessive wage increases in October. The problem of relative wages should be addressed over the longer run, but in the immediate future it was essential to maintain overall wage restraint if the trends in inflation and inflationary expectations were to be reversed.

In recent years the fiscal deficits had been large, expenditures as a share of GDP had been rising, and the tax system had been in need of reform, Mrs. Walker noted. The decline in the ratio of the deficit to GDP from 9 percent in 1983/84 to 7 percent in 1984/85 and the expectation that the deficit in 1985/86 would be substantially less than the 5 1/4 percent figure in the medium-term projection was encouraging. The slight decline in the ratio of expenditure to GDP in 1984/85 was a positive step. If possible, the authorities should make further cuts in the present fiscal year in order both to reduce the deficit and to eliminate some distortions in the economy. The planned tax reform measures should be implemented as soon as possible, particularly to reduce the disincentives created by the reliance on direct taxes--which accounted for 72 percent of total revenues--and by the top marginal personal income tax rate of

66 percent. The new goods and services tax should facilitate the reform of the personal income tax, including a reduction in exemptions and a flattening of rates. There was some danger that the new tax could cause a one-time increase in prices unless financial policies were kept tight.

The apparent deceleration in the growth of the monetary aggregates was a key to the effort to tighten policies, Mrs. Walker said. The authorities' reluctance to set monetary targets was understandable, but they should act as quickly as possible to slow the growth of money aggregates as part of the overall effort to control the growth of national income and inflation. Good progress had been made in the area of monetary reform.

The floating of the New Zealand dollar should provide some additional room for maneuver in monetary policy and permit the authorities to dismantle the widespread import controls and export supports, Mrs. Walker commented. During the previous Article IV consultation, her chair had noted with sympathy the authorities' complaint about the adverse effects of protection abroad on New Zealand's efficient agricultural exports but had stressed that protection in New Zealand undercut the authorities' position. The plans to reform the export support system and to reduce import controls were therefore particularly welcome. The various import measures should free a large number of goods from any licensing requirement by 1986, and all licensing was to be eliminated by the end of the decade. She wondered whether the planned tariff reform might not offer the opportunity to accelerate the elimination of quantitative controls.

The staff's medium-term scenario and sensitivity analysis suggested that the ratio of foreign total debt to GDP by the end of the 1980s would fall from more than 60 percent to a little more than 45 percent and that the debt service ratio would decline slightly, from 32 percent to 30 percent, Mrs. Walker noted. The reversal in those worrying trends in recent years was welcome, but the absolute levels of debt and debt service would remain high.

The economy was clearly in a state of transition, and the benefits of the new policy approach would take some time to materialize, Mrs. Walker concluded. She hoped that the authorities would maintain their strategy even in the face of the likely negative short-term effects of the tighter financial policies.

Mr. Sugita commented that the authorities had undertaken far-reaching reform measures that marked a clear departure from past policies based on substantial government intervention in the economy. The authorities were to be commended for the new strategy and for their careful planning and decisive steps in implementing it. The new economic policy was not risk-free, but if implemented with determination it would eventually reduce the foreign debt burden, one of the most serious consequences of past economic policies.

The authorities were determined to reduce sharply the fiscal deficit over the coming three years, Mr. Sugita noted. To that end they planned to stress expenditure cuts and had not ruled out the possibility of increasing revenues. They also planned to undertake a tax reform that would add a goods and services tax to the present system, which already relied heavily on direct taxation. Tax reform per se was acceptable. However, the attempt to increase and broaden the revenue base might weaken the authorities' determination to maintain tight control over expenditures. Given the large size of the government deficit and of the external debt burden, the authorities should persevere in restraining government expenditure even though they also planned to undertake tax reform.

Mr. Vasudevan said that the new Government's policy reorientation should have a positive effect on the economy. The trade liberalization was welcome; the Generalized System of Preferences was to be extended by providing the 36 least-developed countries with duty-free entry into New Zealand for all their imports. The authorities' commitment to reach the target for official development assistance of 0.7 percent of GDP was commendable. New Zealand's official development assistance had been increased in 1983/84 and was expected to rise further in 1984/85. The authorities should increase such assistance as a percentage of GDP.

The Deputy Director of the European Department remarked that the New Zealand authorities had made wide-ranging changes in the formulation and conduct of economic policy in a brief period. There was little likelihood that the authorities could have made even faster progress in recent months. Indeed, the staff hoped that the economy would be able to adjust to the dramatic changes without any disturbance. In the circumstances, it seemed unfair to ask New Zealand to accelerate its program of reducing import licensing and tariffs, as some Executive Directors had suggested, when the restrictions on New Zealand's exports were among the heaviest facing any Fund member.

The staff, like some Executive Directors, was somewhat concerned about the likely evolution of wages in the near future, the Deputy Director said. In that connection, firm financial policies as well as continued tripartite discussions would be of crucial importance. There was no particular reason to feel complacent about the likely outcome of the tripartite negotiations. In 1984 the trade unions had pressed for wage increases of about 10 percent while the authorities had favored an adjustment of 4 percent. They had eventually struck a compromise at around 7 percent. Since then, business profits had clearly been high and the unions had exercised restraint. The Minister of Finance had given careful thought to other possible means--in addition to the maintenance of strict financial policies--of ensuring the success of the tripartite discussions.

While Executive Directors clearly hoped to see a slowdown in the rate of monetary expansion in the coming period, they had noted the difficulty in interpreting the movements in the monetary and credit aggregates in view of the measure of financial deregulation that had been taken, the

Deputy Director commented. Some Executive Directors apparently felt uneasy about the staff's conclusion that in the present circumstances setting a monetary target would not be entirely appropriate. The authorities did not have a conventional monetary target and had clearly stated that they intended to fully fund the public sector deficit through sales of medium- and long-term government securities. Accordingly, if the authorities adhered to their policy of maintaining a clean float, they would be able to maintain full control of the monetary base. Indeed, action would have to be taken to permit some growth in the monetary base. Hence, although the authorities did not have a formal monetary target, they would be able to maintain tight control over one of the most important monetary aggregates.

The authorities were fully aware of the need to maintain adequate prudential supervision of financial institutions in the new and increasingly competitive environment within the financial system, the Deputy Director remarked. On page 47 of SM/85/145 the staff had noted that the Reserve Bank was upgrading its system of prudential supervision and surveillance of the activities of financial institutions in order to reduce the risks associated with increased competition and to ensure the stability of the financial system.

The authorities were considering the possibility of a relatively gradual introduction of the goods and services tax, the Deputy Director said. That approach was strongly favored by some Labor Party members. As the next general election was to be held in mid-1987, the Government faced the choice of fully introducing the new tax at the beginning of 1986 and then spending subsequent months trying to contain the new tax's inflationary effect, or introducing a more moderate tax measure in 1986 and a second one in 1987, shortly before the election. The authorities apparently wished to press on with the new tax; the Minister of Finance was fully aware of the potential dangers but was confident that the situation could be handled.

The authorities had decided to tackle the difficult issues of import licensing and export subsidies before turning to tariff reform, the Deputy Director noted. Trying to achieve progress in all those areas simultaneously would run the risk of undermining adjustment in the short run, particularly in the manufacturing sector.

As the staff understood it, the authorities intended to review business taxation in terms of the comprehensive review of the tax and welfare systems announced in the budget for 1984, the Deputy Director continued. The authorities had in fact already made a change in corporate tax arrangements in 1984 by introducing a tax on fringe benefits. Moreover, the phasing out of export assistance effectively changed the industry's tax position.

There was little risk that the introduction of the goods and services tax would weaken the authorities' determination to control expenditure, the Deputy Director considered. The Government had clearly indicated that the tax would be revenue-neutral: revenues raised by the new tax would in effect be returned in the form of income tax reductions or compensatory benefits given to low-income persons adversely affected by the new tax. The new tax would not give rise to a net increase in revenues and therefore would not encourage the authorities to step up spending.

The changed external current account projection for 1985/86 worsened the medium-term debt outlook, the Deputy Director remarked. However, in New Zealand, as in many other member countries, forecasting even the short-term behavior of the terms of trade was especially difficult. The projected deterioration in the external current account should not necessarily be viewed as a trend. The devaluation together with the other structural reform measures promised to encourage exports, provided that other countries did not increase their restrictions and that New Zealand made a more efficient use of imports.

It was true that containing the external current account deficit to 2 percent of GDP was critically dependent upon export expansion and therefore upon competitiveness, the Deputy Director continued. The staff had recommended that domestic financial policies should be framed with an eye on the exchange rate. In drawing that conclusion the staff had been aware that in present circumstances it was difficult to deduce from the behavior of monetary aggregates and interest rates precisely how tight monetary policy actually was. The staff suspected that if there were an unexpected weakening of the exchange rate, the Reserve Bank would wish to consider whether monetary policy was adequately tight. In the past, New Zealand had occasionally experienced large and volatile capital flows. Speculative capital inflows in New Zealand would be unwelcome at the present stage, as they would push up the exchange rate, thereby making the economy less competitive and undermining the adjustment of the external current account. The staff favored intervention in the exchange market when necessary to prevent an appreciation of the exchange rate that was not justified on the basis of fundamental trends in the economy.

The changes in the Generalized System of Preferences were scheduled to take effect on July 1, 1985, the Deputy Director said.

There were persistent problems in collecting adequate data to assess the profitability of individual industries within the manufacturing sector, the Deputy Director of the European Department remarked. However, it was clear that the gross profits of manufacturing industries had risen strongly over the previous two years. The staff had no information on profit rates and the rate of return on capital and would look into those matters during the next consultation discussions.

Mr. de Groote said that the absence of aggregate monetary targets was not a cause for concern, but the authorities' incomplete understanding of the mechanisms that linked base money and broad money was worrying. Moreover, basing monetary policy on a program of selling medium- and long-term government securities seemed dangerous and inconsistent with the longer-run objective of ensuring that the private sector would have sufficient liquidity to expand and play a stronger role in the economy. The staff had explained that in the absence of a clear understanding of the relationship between primary liquidity and the broader monetary aggregates the authorities intended to rely on movements in short-term interest rates to guide their money market management. However, the current movement in short-term interest rates seemed inconsistent with the need to fund fully the public sector deficit, which was the main objective of monetary policy.

The Deputy Director of the European Department responded that Mr. de Groote's point concerning the desirability of increasing the role of the private sector was well taken. The planned reduction in the fiscal deficit to 2 percent of GDP in the coming period, compared with 9 percent in the recent past, should create room in which the private sector could expand. In that connection, however, recent and prospective developments in interest rates were worrying. It was difficult to explain why nominal and real interest rates in New Zealand were so high. Apparently the authorities hoped that reductions in the fiscal deficit would be followed by at least a downward trend in interest rates that would contribute to the expansion of the private sector.

Mr. Rye said that the authorities understood that the dramatic change in the direction of economic policies would involve short-term costs. In general, they wished to make policy changes as early as possible in the three-year electoral cycle. The new budget that was to be presented in the immediate future would reflect the expenditure restraint that a number of Executive Directors had recommended, with a considerably lower deficit than had been expected. It would not contain considerable revenue-raising measures, as the authorities planned to formulate a supplementary budget in September 1985 that would include a goods and services tax and income tax reductions as well as restructured welfare benefits, all of which would take effect on April 1, 1986. Moreover, corporate taxes were under review; any changes would be made known in September 1985.

The fact that the wage freeze introduced by the previous Government had succeeded in halting the rapid upward trend in wages suggested that the trade union movement did not have as much influence as had been suspected, Mr. Rye remarked. The trade unions had a considerable stake in the Government's policies: the failure of those policies might well lead to a new administration and even more drastic policy changes.

The authorities were studying possible appropriate forms of monetary targets, and the introduction of such targets probably would be seriously considered as soon as the study was completed, Mr. Rye said. A possible solution was to use a range of aggregates rather than focus on a particular one, such as M-3. Finally, in assessing the authorities' external policies it was important to remember that the barriers abroad to New Zealand's exports were substantial.

The Chairman made the following summing up:

Executive Directors welcomed the striking change in economic policies in New Zealand since the last consultation. It was noted that the new Government, which came into office in July 1984, inherited an economy suffering from large structural imbalances accumulated over a long period. These imbalances were reflected in the large and rising fiscal deficit, in sizable deficits in the external current account, and in the erosion of competitiveness which had led to a rapid buildup of external debt and a foreign exchange crisis.

Directors commended the authorities for acting with unusual swiftness and decisiveness in coping with the difficult situation that they had inherited. Their main policy actions, including the decision to devalue the New Zealand dollar by 20 percent and subsequently to float the exchange rate, the lifting of controls on interest rates, the introduction of a comprehensive program of deregulation of the financial system, the beginning of the process of dismantling the system of export supports and import quotas, and their strategy to reduce the budget deficit and reform the tax system were viewed by Directors as long overdue steps in the right direction. Directors expressed full support for the general economic strategy of the authorities of moving away from regulation and controls toward greater reliance on market forces and welcomed especially the medium-term orientation of policies.

Directors cautioned that the scope and speed of changes were such that the economy faced a difficult period of transition. They noted the recent strong performance of exports and investment and the increase in employment. However, economic growth was likely to slow as domestic demand weakens. Moreover, inflationary expectations still seemed to be strong, despite the Government's announcement and implementation of firm financial policies and a relatively modest wage round toward the end of 1984. Directors noted the difficulty of the task of dampening inflationary expectations and underlined the need for continued restrained fiscal and monetary policies.

Directors welcomed the measures taken in the budget for 1984/85 to contain the growth of public spending and the plans for the introduction in April 1986 of a goods and services tax. Directors welcomed the indication that the 1985/86 government budget deficit may be significantly less than the 5 1/4 percent of GDP figure included in the Treasury's medium-term projections. They encouraged the authorities to maintain tight restraint on government expenditure until a sustainable fiscal position has been restored. The determination of the authorities to put emphasis on the commercial character of public enterprises in general was welcomed.

Noting the recent restraint on wage costs, Directors nevertheless expressed concern that the next wage round might produce excessive wage demands, especially in a climate of brisk business profits, and that the impending introduction of the goods and services tax might accelerate the momentum of inflation by feeding through into wage increases. These risks on the wage front, in the view of Directors, reinforced the importance of adhering to firm financial policies. Several Directors noted the Government's intention to use net revenue raised by the new goods and services tax to reduce income taxes and improve welfare benefits, with particular attention to be given to low-income earners. These offsetting actions, together with the pursuit of tripartite discussions, could be instrumental in holding down wage demands and inflation.

Directors welcomed the floating of the exchange rate as a step which would facilitate the maintenance of monetary control. They thought that continued firmness of monetary policy was essential, not the least because the credibility of policy was yet to be firmly established. They therefore urged the authorities to remain firm in their resolve to accept the short-term costs of their anti-inflationary strategy in terms of high nominal and real rates of interest.

Directors thought that the competitive position of the traded goods sector had improved substantially as a result of the July 1984 devaluation of 20 percent and the relaxation of import licensing. Directors strongly welcomed the sharp reduction in quantitative import controls and export supports that was already undertaken and envisaged for the future. Several Directors urged New Zealand to accelerate the momentum of external liberalization. Directors felt that as the favorable effects of the policies to eliminate inflationary expectations and to strengthen the competitiveness of the economy came through, the medium-term outlook for the external current account and the official external sector debt should brighten.

Finally, in commending the authorities for the courageous and enlightened course of economic policy on which they had embarked, Directors encouraged them to persist on this course with patience and firmness until the benefits of the new policy were fully realized.

The next Article IV consultation with New Zealand is expected to take place on the normal 12-month cycle.

3. PEOPLE'S DEMOCRATIC REPUBLIC OF YEMEN - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with the People's Democratic Republic of Yemen (SM/85/133, 5/13/85), together with a proposed decision concluding the 1985 Article XIV consultation. They also had before them a report on recent economic developments in the People's Democratic Republic of Yemen (SM/85/147, 5/23/85).

Mr. Finaish made the following statement:

Economic policy in the People's Democratic Republic of Yemen is conducted within the framework of a centrally planned socialist economy. Since the country's independence, the authorities have pursued the twin objectives of mobilizing the country's limited resources toward diversified growth while providing for the basic needs of the population within an equitable system of income distribution. In the decade prior to 1982, considerable progress was made toward these objectives as reflected in the significant improvements in the physical infrastructure and human captial and the expansion of the productive sectors at fairly rapid rates. During the same period, the economy was characterized by financial stability and a balanced external position, which was aided by foreign exchange flows from workers' remittances and external assistance. The severe floods of 1981-82 and the drought which followed have resulted in a major setback to the development process and put the country's finances under considerable strain. The adjustment efforts that the authorities have been making since 1982 have been rendered more difficult by the urgent needs of reconstruction in the wake of the floods, the persistence of drought conditions, and the coincidence of these developments with a slowdown in foreign exchange flows from workers' remittances and external assistance.

During 1983-84, the authorities followed a policy of financial restraint. The rising fiscal deficit was contained in 1983 and reduced substantially in 1984 owing to measures on both expenditure and revenue sides. Perhaps the most significant of these was the almost total elimination of budget subsidies, which in 1981 had constituted about 11 percent of current expenditures. The excess liquidity generated by the budget deficits was partly absorbed by increasing the deposits of the National Bank of Yemen with the Central Bank, which is tantamount to raising the reserve requirement. As a result, growth in domestic liquidity continued to decelerate. In spite of this improvement in the fiscal and monetary situation, the external position continued to weaken. Although imports fell in 1983 and 1984, the current account deficit widened as a result of stagnation in workers' remittances and a sharp drop in external grants. Moreover, the overall deficit increased markedly in 1984 mainly because of a reduction in net drawings on foreign loans.

The growth performance in 1983-84 continued to be dominated by the effects of the adverse weather conditions on agriculture. GDP grew by only about 2 percent, although sectors other than agriculture, mainly fisheries and industry, fared better. The performance of these two sectors was helped by the introduction of a number of measures designed to increase efficiency through wage and price incentives and, in the case of small-scale manufacturing, to increase private sector activity through enhanced profit incentives. Private sector participation in larger industrial projects was also encouraged.

The restrained stance of financial policies is to be maintained in 1985. The fiscal position, however, will continue to be strained. In spite of a further decline in expenditures in real terms, current projections indicate a likely widening of the budget deficit. The authorities agree with the staff on the need for further mobilization of domestic revenues. For this purpose, consideration is being given to the implementation of the recommendations with respect to customs duties of the recently completed technical assistance study by the Fund, and to increasing receipts from fees and charges as well as direct taxation. In addition, electricity rates are expected to be raised and energy prices are currently being reviewed. Adjustments in the prices of other public sector goods and services are also being considered. The external position, on the other hand, is expected to show some improvement in 1985. With a projected decline in imports for the third year in a row and an increase in drawings on foreign loans, both the current account and overall deficits are expected to decline.

The authorities are in broad agreement with the staff on the general policy stance that is needed to deal with the current economic situation. They do not exclude any of the economic policy instruments available to them, including the exchange rate and interest rates, which are under review. However, while they share the staff's concern about the external position and recognize that a devaluation might lead to an increase in remittances, they feel that other considerations also need to be taken into account with respect to exchange rate policy. The country's exports have low price elasticity and are determined more by other factors, such as water in the case of crops. Moreover, any positive budgetary impact of a devaluation has to be balanced against its inflationary effects. Similarly, the authorities do not consider interest rates to be a very important factor in mobilizing domestic savings or attracting funds from abroad. The present interest rate structure is geared toward encouraging investment within the framework of the Development Plan. However, the authorities will give special consideration to increasing interest rate flexibility.

> Finally, the authorities are determined to continue and strengthen their adjustment efforts in the period ahead. Supported by prudent financial policies, and within the institutional framework of a centrally planned economy, the Third Development Plan (1986-90) is expected to focus on ways of improving productivity and growth, including the introduction of new incentive schemes and shifting investment toward directly productive sectors. The prospects for achieving financial stability along with faster growth over the medium term are helped by the relatively comfortable external debt position. The low debt service ratio is a reflection of the authorities' emphasis on domestic resource mobilization and of their ability to obtain most of the foreign loans on concessional terms.

Mr. Nimatallah remarked that the Fund-supported financial program implemented in 1982 and the corrective measures adopted in subsequent months had led to a reduction in the fiscal deficit in 1984. However, the severe drought during the previous three years had limited agricultural output, international aid had declined sharply, and workers' remittances from neighboring oil producing countries had stagnated. As a result, the public finances were expected to weaken in 1985 while external reserves were expected to decline further.

He generally agreed with the staff appraisal, Mr. Nimatallah continued. There was an urgent need for additional far-reaching measures to control public spending. The measures under consideration were in the right direction, but they need to be strengthened.

The increase in government employment in 1984, the sharp rise in social spending, and the authorities' increased reliance on domestic bank credit to finance government operations were a cause for concern, Mr. Nimatallah remarked. The expected sharp increase in government borrowing in 1985 would accelerate monetary growth and intensify price pressures.

The authorities should evolve medium-term policies to alleviate the effects of the drought, the decline in aid, and the stagnation of remittances, Mr. Nimatallah considered. They could initiate additional irrigation projects--which could qualify for assistance from the World Bank or other development organizations--to enhance agricultural production over the medium term. In addition, they could adopt a much more flexible exchange rate policy to encourage inflows of remittances. Those flows could be strengthened further by additional incentives to encourage private sector activities.

The authorities were to be commended on the measures they had introduced, but they should strengthen their efforts in light of the serious imbalances still facing the economy, Mr. Nimatallah concluded. The proposed decision was acceptable.

Mr. Salehkhou remarked that the country's economic and financial performance during the previous three years had been severely strained by the unusually heavy floods in 1982, which had considerably damaged the infrastructure and adversely affected agricultural output as well as the fiscal and external positions. At the same time, the country had suffered from a major deceleration in the growth of its two main sources of revenue, namely, workers' remittances and assistance by friendly countries. The floods--which had been followed by an extended period of drought--had interrupted nearly a decade of rapid economic growth and relative financial stability owing to a sound development program and cautious financial policies. Those policies, supported by large and highly concessionary capital inflows, had enabled the Government to overcome the constraints caused by the extremely limited resource base, and to make commendable progress in meeting the population's basic needs, in expanding infrastructure, and in achieving a structural transformation designed to increase the role of commodity production. However, the floods had forced the authorities to reorient their policy efforts and priorities toward rehabilitation and reconstruction.

Despite the implementation of financial measures to contain the deterioration in the fiscal and external accounts, and despite the success of the 1983 financial program adopted in cooperation with the Fund following an emergency drawing on the Fund's resources, real economic growth had remained weak and the imbalances in the economy had remained large, Mr. Salehkhou went on. The difficulties were expected to continue in 1985. The authorities had sought to offset some of the impact of the diversion of resources from productive investment to reconstruction through the implementation of a large number of measures aimed at improving operating capacity and stimulating productivity. Some of those measures had been designed specifically to enhance the role of, and profitability within, the private sector and to increase the flexibility of pricing policy. Reforms in the agricultural and industrial sectors understandably had had only a limited effect on growth in the short run. They should be accelerated under the next five-year development plan and supplemented by stronger fiscal and external adjustment efforts.

The authorities seemed to agree broadly with the staff's assessment of the fiscal situation and with the proposed measures to contain the growing deficit in the public finances, Mr. Salehkhou remarked. With the technical assistance of the Fund and the World Bank the authorities could mobilize domestic resources by increasing energy prices, improving the financial position of public enterprises, and raising customs duties. The adjustment of the duties would partly compensate for the sharp appreciation of the dinar over the previous several years. Expenditure restraint would help to reduce the huge fiscal deficits and the Government's reliance on domestic bank financing.

He agreed with the staff that the deceleration in the growth of domestic liquidity should be continued in order to contain inflationary pressures and reduce the reliance on price controls, but it should not be automatically assumed that positive real interest rates were required in the circumstances of the People's Democratic Republic of Yemen, Mr. Salehkhou said. The banking system was limited, and the slower growth of workers' remittances was probably due to the host countries' sluggish economic activity and their attempts to curtail the proportion of foreign workers; incentives introduced by the Yemeni Government probably would not have a substantial impact on workers' remittances. Moreover, since the economy was centrally planned, credit allocation depended more upon development policy priorities than on the structure of interest rates.

The deterioration of the balance of payments seemed to have accelerated somewhat in 1984, mainly because of the sharp decline in foreign assistance, Mr. Salehkhou commented. Imports had been curtailed, but the deterioration in the balance of payments had led to a further decline in official reserves and in the net foreign assets of the National Bank. The considerable appreciation of the exchange rate, owing largely to the pegging of the dinar to the U.S. dollar, would complicate the authorities' efforts to correct the external imbalance, particularly in light of the country's heavy dependence on imports to meet consumption and investment demand. The external debt remained small and easily manageable, but the sharp rise in debt service payments projected for 1985 called for close monitoring of the debt situation and for additional concessionary financing.

The authorities were to be commended for their vigorous development efforts despite the considerable natural constraints, and for their generally cautious policies, Mr. Salehkhou concluded. The proposed decision was acceptable.

Mrs. Walker remarked that the People's Democratic Republic of Yemen had been able to sustain the economy's development over two successive development plan. However, in the recent past adverse weather conditions, changes in the external economic environment that had resulted in a decline in foreign assistance, and increasingly evident strains within the centrally planned economy had weakened the fiscal and external sectors. Further policy action was clearly called for.

The fiscal position had worsened considerably in 1981/82 and had improved somewhat in 1983/84 owing to the limitation on expenditure growth and the increase in domestic receipts, Mrs. Walker continued. The most significant measure recently adopted was the reduction in subsidies for commodities handled by the Price Stabilization Fund in line with the fluctuations in international commodity prices. The decline in international commodity prices in 1983/84 had been a major factor in the fall in government subsidies in 1984. A continued low level of government subsidies would play an essential role in achieving the desired improvement in the fiscal position; staff comment on the sustainability of such a level in coming months would be helpful.

The authorities should take steps to improve the budget situation, Mrs. Walker considered. There was some uncertainty about the required amount of expenditure restraint and revenue generation because the preliminary budget estimates for 1985 had been made before all the relevant data for 1984 had been collected. The staff's budget estimates had provided a framework within which the authorities had been able to make budgetary plans for fiscal year 1985, but she wondered what might be done in the future to facilitate the formulation of more reliable estimates in advance of the presentation of a new budget. The available estimates clearly suggested that the fiscal position would continue to be strained in 1985. The authorities were aware of the problem and were considering the adoption of certain far-reaching measures recommended by the staff, particularly in the areas of energy and public sector pricing.

The authorities' efforts to use price incentives to promote efficient production throughout the economy and private sector activity in the agricultural sector in particular were encouraging, Mrs. Walker remarked. The expansion of the system introduced in 1984 under which wages in the Port Authority were based on output performance had apparently helped to restrain the growth of current expenditure and to improve productivity. Moreover, the authorities had increased the profit incentives for small-scale manufacturing enterprises in order to encourage private sector activity. However, private sector borrowing had been restrained, owing partly to the small amount of private sector activity in the economy and to the limited success of past efforts by the authorities to increase growth and efficiency in several key economic sectors. In implementing the Third Development Plan the authorities should follow through on their intention to focus on ways of improving productivity and growth through new incentive schemes and by shifting investment toward more productive sectors. A more flexible overall pricing system would also be helpful. All those efforts would have to be accompanied by actions in the fiscal and external sectors.

The external position had weakened since 1982, Mrs. Walker noted. The negative current account balance had been financed mainly by the significant inflow of workers' remittances, but the growth of those remittances had recently leveled off. Furthermore, official grants had significantly declined over the previous several years, and although debt service payments were still relatively low they were scheduled to increase throughout the rest of the 1980s. To improve the balance of payments prospects the authorities should seriously consider taking policy actions in the interest rate and exchange rate areas. A more flexible interest rate policy would help to attract more workers' remittances and could help to make resource allocation more efficient and to encourage saving. Exchange rate action also could encourage remittances and provide an alternative--and perhaps more efficient--mechanism for assessing import requirements. Finally, the exchange system was complex, and the proposed decision was acceptable.

Mr. Abdallah stated that he broadly agreed with the staff appraisal. The Yemeni authorities seemed to be more flexible in their approach to economic management than the authorities of many other countries with centrally planned economies. They had used the price mechanism flexibly, had taken steps to enlarge the private sector, and were open to additional suggestions, provided that they were consistent with the primary objectives of maintaining income growth and an appropriate income distribution.

The authorities must take steps to reduce the huge trade imbalance, Mr. Abdallah considered. Although the imbalance was obviously unsustainable, the authorities were unlikely to be able to reduce it significantly even in the medium run; still, every effort must be made to do so. As Mr. Nimatallah had recommended, agriculture should be developed to ensure adequate production of commodities; such efforts might well attract external funding, including concessional assistance. In addition, the authorities should encourage the development of the fishing industry; Yemeni territorial waters were well stocked and the People's Democratic Republic of Yemen had traditionally been an exporter of dried fish to many countries, including those in East Africa.

The services sector--particularly tourism--also seemed to offer ample scope for development, Mr. Abdallah said. The country enjoyed a varied landscape and a long coastline, and the Government and people had an open outlook. In earlier years the capital--which was a free port--had attracted many visitors. Finally, the proposed decision was acceptable.

The staff representative from the Middle Eastern Department commented that the decline in government subsidies in 1984 had been due almost exclusively to the fall in international commodity prices. However, the authorities had occasionally raised the prices of commodities handled by the Price Stabilization Fund--most recently in 1981/82--and the authorities were considering whether those commodities should remain within the Price Stabilization Fund; moreover, given the present tight fiscal situation, the prices of those commodities might well be further adjusted.

Mr. Finaish remarked that speakers had shown an understanding of the difficult situation in the People's Democratic Republic of Yemen arising from a combination of internal and external factors, including the major floods of 1981/82, the subsequent extended drought, the changes in the international economic and financial situation, and oil developments in the region. The decline in the flow of workers' remittances and in external aid--a major source of foreign exchange--was reflected in the balance of payments and the budget. The authorities had responded by undertaking a substantial adjustment effort, including significant structural measures designed to increase pricing flexibility and to encourage the private sector.

The authorities agreed with the staff that the coming period would be a difficult one and that a strong adjustment effort based on a reduction in the fiscal deficit would continue to be required, Mr. Finaish said. The present projections indicated that the fiscal deficit would increase in 1985, but the authorities planned to implement a number of additional measures to increase revenues. They also intended to maintain expenditure restraint; despite the difficult conditions in the country the authorities had been able to reduce expenditures significantly in real terms in 1983 and 1984.

The authorities had an open mind on the use of the various available policy tools in the coming period, Mr. Finaish remarked. They were keeping interest and exchange rate policies under review, although certain particular circumstances limit the effectiveness of both policies. The major contributions to mobilize savings would be expected from the spreading of banking habits and increasing the efficiency of the banking services as well as the number of branches of the National Bank. Domestic savings were constrained by low per capita income, and their responsiveness to interest rate changes was limited. Most nonresident deposits were held by nonnationals and would not be significantly affected by interest rate adjustments. The authorities recognized that interest rates had an important effect on resource allocation, and they were using differential interest rates to encourage investment within the framework of the development plan.

The potential for export promotion through policy action in the exchange rate area was insignificant, Mr. Finaish noted. The volume and number of exports were limited and were affected mainly by supply factors, especially weather conditions. They were not particularly sensitive to exchange rate movements.

The fishing sector was important and the authorities were paying considerable attention to it, Mr. Finaish remarked. Substantial progress in that sector had been made over the previous three years. Scope existed for developing tourism in certain parts of the country, and an increase in irrigated farming was also possible. The financing of such development was a critical issue. The emphasis in the development of the economy on infrastructure was smaller under the latest development plan than under previous ones. The authorities had had to devote a substantial portion of resources available over the previous two years to repairing the damage caused by the major floods.

The Chairman made the following summing up:

Executive Directors expressed general agreement with the thrust of the staff appraisal in the report for the 1985 Article IV consultation with the People's Democratic Republic of Yemen.

The economy continues to suffer from the impact of the heavy floods of 1982 and the subsequent drought, which still persists, as well as from the sharp decline in foreign aid receipts and the slowdown in workers' remittances. Mainly, as a result of these factors, there was a slowdown in growth rates in recent years and indications are for lower growth rates in the medium term.

Directors took note of the efforts made in 1984 to raise additional domestic resources and to restrain expenditures. However, the fiscal position remains strained despite commendable action to reduce budget subsidies.

Directors noted that the financial prospects for 1985 were adverse: the budget deficit is forecast to expand considerably; the drain on external reserves is expected to continue; and the external debt service burden, though still relatively low, is on the rise.

In view of the weak balance of payments situation and prospects, Directors encouraged the authorities to take steps to promote economic efficiency and competitiveness and to provide the necessary incentives for productive private sector activity in order to expand the production of exports and import substitutes while selecting profitable development-oriented projects.

A flexible interest rate policy and an early reversal of the substantial appreciation of the dinar were recommended by some Directors as desirable steps for strengthening the external payments position and restoring financial stability.

It is expected that the next Article IV consultation with the People's Democratic Republic of Yemen 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 1985 Article XIV consultation with the People's Democratic Republic of Yemen, in the light of the 1985 Article IV consultation with the People's Democratic Republic of Yemen conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The People's Democratic Republic of Yemen continues to maintain a comprehensive system of controls, some of which constitute restrictions on payments and transfers for current international transactions under Article XIV, as described in SM/85/133. The Fund encourages the authorities to take appropriate measures to simplify the exchange system.

Decision No. 8003-(85/93), adopted
June 10, 1985

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/85/92 (6/7/85) and EBM/85/93 (6/10/85).

4. SIERRA LEONE - OVERDUE FINANCIAL OBLIGATIONS - REPORT AND COMPLAINT UNDER RULE S-1

1. The complaint of the Managing Director dated June 4, 1985, regarding Sierra Leone's overdue obligations in the SDR Department (EBS/85/142, 6/4/85), is noted. It shall be placed on the agenda of the Executive Board for June 28, 1985.

2. Consideration of the complaint in accordance with Rule S-1 particularly affects Sierra Leone. The member shall be informed by rapid means of communication of this matter and of its right to present its views through an appropriately authorized representative.

Decision No. 8004-(85/93) S, adopted
June 7, 1985

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/85/147 (6/6/85) is approved.

APPROVED: March 28, 1986

LEO VAN HOUTVEN
Secretary