INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 92/11

10:00 a.m., January 31, 1992

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
M. Al-Jasser	A. A. Al-Tuwaijri
	L. E. N. Fernando
Che P.	Wei B.
C. S. Clark	
T. C. Dawson	
J. de Groote	
E. A. Evans	
R. Filosa	
M. Finaish	
I. Fridriksson	
H. Fukui	N. Tabata
B. Goos	B. Esdar
	T. Sirivedhin
A. Kafka	
J.-P. Landau	I. Martel
	O. Kabbaj
	M. J. Mojarrad, Temporary
L. B. Monyake	L. J. Mwananshiku
	P. Wright
G. A. Posthumus	Z. Trbojevic
	J.-C. Obame, Temporary
	R. Marino
A. Végh	

L. Van Houtven, Secretary and Counsellor
L. Collier, Assistant
K. S. Friedman, Assistant

Also Present

IBRD: I. Guerrero, Europe, Middle East and North Africa Regional Office. African Department: M. Touré, Counsellor and Director; E. L. Bornemann, Deputy Director; E. A. Calamitsis, Deputy Director; J. A. Clément, P. Dhonte, S. Eken, A. J.-P. Feler, M. M. Lazare, S. M. Nsouli. European I Department: M. Russo Director; J. Artus, Deputy Director; C. Atkinson, J. De Gregorio, M. A. Galy, T. Krueger, L. E. Molho, E. Spitäller, R. Violi, H. Vittas. Exchange and Trade Relations Department: J. Ferrán, Deputy Director; A. Basu, P. K. Cornelius, E. R. J. Kalter. External Relations Department: S. J. Anjaria, Director. Fiscal Affairs Department: M. Cangiano, X. Maret. Legal Department: W. E. Holder, Deputy General Counsel; P. L. Francotte, R. B. Leckow. Research Department: L. Bartolini, F. Larsen. Secretary's Department: A. Jbili, A. Leipold. Treasurer's Department: C. Kelly. Western Hemisphere Department: L. Schmitz. Personal Assistant to the Managing Director: B. P. A. Andrews. Advisors to Executive Directors: J. M. Abbott, M. A. Ahmed, P. Bonzom, C. D. Cuong, B. R. Fuleihan, Y.-H. Lee, E. Martínez-Alas, A. Raza, B. Szombati. Assistants to Executive Directors: T. S. Allouba, J. A. R. Almeida, G. Bindley-Taylor, B. Bossone, J. H. Brits, J. A. Costa, S. B. Creane, M. Da Costa, Duan J., S. K. Fayyad, A. Giustiniani, H. Golriz, M. A. Hammoudi, M. E. Hansen, K. Ishikura, J. Jamnik, J. Jonas, W. Laux, L. J. Morelli, F. Moss, M. Mrakovcic, L. F. Ochoa, E. H. Pedersen, R. K. W. Powell, E. Quattrochiocche, S. Rouai, R. Thorne, Tin Win, C. M. Towe.

1. REPUBLIC OF SLOVENIA - APPLICATION FOR MEMBERSHIP

The Managing Director informed the Board that an application for membership from the Republic of Slovenia had been received in the Fund on January 30, 1992 (EBD/92/20, 1/31/92). He noted that the staff would be preparing a background note on the international status of the applicant.

2. ITALY - 1991 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1991 Article IV consultation with Italy (SM/92/3, 1/3/92; and Sup. 1, 1/30/92). They also had before them a background paper on recent economic developments in Italy (SM/92/6, 1/17/92; and Sup. 1, 1/24/92).

Mr. Filosa made the following statement:

Reflecting the pattern prevailing in other industrial countries, the slowdown in economic growth in Italy that started in 1990 became, in 1991, more pronounced than previously anticipated. The standstill of exports and investment is the main cause of the greater than expected deceleration in economic activity. The weakness of domestic demand and the improvement in the terms of trade, however, were insufficient to narrow the current deficit of the balance of payments, which remained, in terms of GDP, at about the same level as in 1990. This, together with a reduction in the net capital inflow, brought about a decline in official reserves, after five consecutive years of significant gains.

Results have been unsatisfactory particularly in two areas: inflation and public finances. In the former case, consumer price inflation, after peaking in the first half of the year, decelerated to 6 percent in December; however, the annual average shows no progress relative to 1990. As to public finances, notwithstanding the corrective measures implemented during the year and the further reduction of the primary deficit, the state sector borrowing requirement overshot the target by 1.4 percent of GDP.

Monetary and exchange rate policy

In this difficult domestic environment, made more complex by repeated changes in international interest rates, monetary policy remained geared to its targets, thereby sending a stability-oriented signal to the economy. Under the constraint of maintaining the fluctuations of the lira's exchange rate well within the narrow band of the exchange rate mechanism (ERM), the monetary authorities sought to restrain the growth of the money supply in order to limit inflationary pressures while allowing interest rates to change in accordance with developments abroad and in the budget.

The task of controlling domestic liquidity benefited from a persistently buoyant demand for government securities. This, in turn, led for the second consecutive year to a negative monetary financing of the Treasury. Nevertheless, the growth of M2 slightly exceeded in the last months of the year the upper limit of the 5-8 percent target band.

The stability of the lira was ensured by a balanced mix of interest rate changes and interventions in the foreign exchange markets along the lines of the Basle-Nyborg Agreement.

Short-term interest rate developments were mainly determined by the different economic conditions and policies that continued to prevail in the major industrial countries and by the ensuing swings in the major currencies. When tensions in the foreign exchange market emerged, concerted interventions--indeed concentrated in limited periods during the year--and smooth changes in short-term interest rate differentials restored stability in the markets. Despite sporadic tensions and an increased exchange rate variability within both the narrow and wide bands, market forces were never such as to question the credibility of the lira and, more generally, the ERM parity grid.

The effectiveness of Italian monetary policy was enhanced, in 1991, by two structural innovations. The first, introduced in October 1990, was a new system for minimum reserve requirements that allowed banks to compute their reserve obligation on a monthly average, rather than on a daily basis. The reform greatly reduced the volatility of short-term rates and made them more suitable as daily operating targets. The second reform (May 1991) gave the Bank of Italy broad discretion in setting the penalty applied to the discount rate for last-resort lending, previously set by the Treasury under the Bank's advice.

A further provision, currently at an advanced stage of parliamentary examination, will make this discretion complete, allowing the Bank to set the discount rate. Finally, the Government has submitted a bill prohibiting monetary financing of the Treasury, currently possible through the overdraft facility. The combination of these reforms will formally sanction the full independence of the central bank, fulfilling, in this matter, the conditions for access to further stages of the European Monetary Union (EMU).

Fiscal policy

Preliminary estimates for 1991 indicate that the level of the state sector deficit targeted in the December 1990 Budget Bill was overshot by 1.4 percent of GDP (Lit 20 trillion). As a consequence, the improvement of the public accounts has been very modest--the deficit/GDP ratio remained broadly constant while the

primary deficit/GDP ratio dropped by 0.6 percent. Public debt rose by 3.4 percent relative to nominal income, reaching 102.6 percent of GDP.

The overshooting of targets is entirely due to lower than expected revenues, despite an increase in taxation that was larger than 1 percent of GDP, since expenditures did not deviate from the projections. Lower than expected growth in 1990 and in 1991 was a significant factor in the deviation from the targeted deficit. However, a large fraction of the fiscal measures decided in December 1990, and in May and September of 1991, made a smaller than expected contribution to the containment of the underlying trend of the state sector borrowing requirement because some of them were not implemented, while the effects of others proved to have been overestimated.

In May 1991, to give momentum to fiscal consolidation, the Government submitted to Parliament a three-year Fiscal Plan, according to which the budget deficit/GDP ratio would be reduced to 8.4 percent in 1992 and almost halved in 1994, relative to its 1991 level, through growing primary surpluses from 1.7 percent of GDP in 1992 to 3.7 percent in 1994.

Well ahead of the final deliberations of the Maastricht European Community (EC) Summit, the Plan explicitly targeted the objectives for fiscal and inflation convergence which EC countries judged necessary for a successful completion of monetary and economic integration in Europe. The 1992 Budget Bill, together with the Fiscal Plan, was voluntarily submitted to the EC under its multilateral surveillance procedure and received the support of the Economic and Financial Council (ECOFIN). The Budget Bill has now been approved by Parliament, with minor modifications vis-à-vis the draft discussed by the staff mission with the authorities.

The detailed analysis of the Bill leads the staff to conclude that while the planned fiscal adjustment is sizable, the composition of the package falls short of what would be appropriate because of the limited scope given to structural adjustments, the one-off nature of some measures, the uncertainty surrounding the effectiveness of some others, and the greater weight of tax increases vis-à-vis expenditure cuts.

The Italian authorities want to stress the following points:

First, they are aware that temporary measures are inconsistent with the need for significant fiscal adjustment through 1994 and beyond and that the limit of their usefulness may have been reached. Therefore, in accordance with the commitment to keep unchanged the nominal values of fiscal targets and consistent with the provisions of the Fiscal Plan, they intend to expand

progressively the share of permanent measures in the adjustment packages that will be prepared for 1993 and 1994. This will strengthen the positive contribution that the restraint in public wages and to a lesser extent the cuts in health expenditures are already making toward the containment of the underlying borrowing requirement.

Second, while the bulk of the projected increase in revenues in 1992 is, by its nature, estimated to fade away quite rapidly, my authorities expect that the reforms now under way will help broaden the tax base permanently. The reform of judicial procedures, the increased costs of noncompliance with tax obligations, and the abolition of bank secrecy for fiscal investigation are all measures that will not only reduce the uncertainties surrounding the amount of revenues stemming from the tax amnesty, but increase future tax receipts. Their expectations are also supported by the positive results that have been obtained in reducing tax evasion. In addition, they plan to introduce a local tax on real estate which, together with the significant upward adjustment of the imputed value of real estate for tax purposes, will significantly reinforce the structural component of revenues in the budget.

Third, a firm wage policy is the backbone of the planned adjustment. In particular, the earnings of public sector employees are to grow in line with the target rate of inflation. Furthermore, the next government should reconsider all factors bearing on the issue of pensions, which is the most important element of disequilibrium in the fiscal accounts, in order to avoid a situation in which overgenerous payments to present workers will result in a fundamentally inequitable redistribution of the country's resources to the disadvantage of future generations.

Fourth, the Privatization Bill, which the Government considers an integral part of its economic strategy, has been recently approved. The sale of public assets would facilitate fiscal convergence, enhance the efficiency of the economy, and promote further development of financial markets. My authorities are aware of the temporary effects of privatization on the growth of public debt and do not regard it as a substitute for permanent measures to contain the underlying borrowing requirement.

Finally, the Treasury strongly holds the view that constitutional amendments increasing the powers of Government relative to those of Parliament in matters concerning the budget are crucial to the effective implementation of the Fiscal Plan.

Inflation convergence and the role of incomes policies

After 1987, the convergence of Italian inflation toward best performers came to a halt and external competitiveness deteriorated. Three main reasons are at the root of this unsatisfactory performance: the re-emergence of conflicts in the distribution of income; the slowdown of productivity in industry; and the divergent trends in wages, productivity, and prices of the industrial and tertiary sectors.

In recent years, the firmness of monetary and exchange rate policies has prevented the widening of the inflation differential with main competitors, but its effectiveness in narrowing it down further has been limited. In the European context, problems of competitiveness cannot be sorted out by the manipulation of the exchange rate since this would be inconsistent with the common commitment to maintaining the European Monetary System (EMS) as an area of monetary stability. In particular, depreciation would not permanently improve competitiveness when inflation results from imperfections in labor and product markets. In these circumstances, sound economic policies should be complemented by the use of instruments that are specific to such markets in order to directly affect the wage negotiation process and to increase product market exposure to competition.

The Fiscal Plan aims to achieve inflation rates of 4.5 percent and 3.5 percent in 1992 and 1994, respectively. Besides the continuation of firm monetary and exchange rate policies and the timely and full compliance with the nominal fiscal targets, a firm incomes policy is instrumental to the achievement of the inflation targets. This view is also reflected in the ECOFIN communiqué endorsing the Fiscal Plan. To complement its own wage policy, the Government has also taken the initiative of promoting a wage moderation agreement in the private sector that would include a fundamental reform of the indexation system and fiscal provisions that do not imply a further burden on the budget, so as to break the inertia of prices and wages and to prevent further deterioration of external competitiveness.

The proposed incomes policy agreement between the Government and social partners is seen by my authorities as a necessary, although temporary, device to reduce inflation and achieve nominal convergence more quickly and in a less costly manner than the use of traditional macroeconomic tools alone would permit. In a longer-term perspective, my authorities believe that, first, the social partners should agree on a new bargaining process that would avoid the well-known shortcomings of the present one; second, the bargaining process should not involve the Government and should not limit its autonomy in the use of fiscal instruments to achieve its macroeconomic objectives; and third, while greater competition in the tertiary sector would be induced by the

completion of the EC market, the newly created Anti-Trust Authority has an important role to play in removing legal barriers to competition.

My authorities hold the view that it would be wrong to interpret the staff's criticisms, particularly in budget matters, as denying that any progress has been made so far, including in 1991. It would be equally inappropriate, in light of the still heavy agenda, to believe that the necessary adjustment is not feasible. The Italian economy is strong enough to achieve the targets set and to sustain the inherent transitional costs.

The ideals that have inspired the founders of the European Community have now, after Maastricht, a concrete possibility of being achieved. It is the common responsibility of all EC countries to gradually transform those ideals into reality. Italy holds a significant share of the responsibility for the successful completion of monetary unification. The presentation to the Community of the Fiscal Plan and the submission to Parliament of draft legislation that would give the central bank full independence attest to Italy's resolve to maintain its active role in the forging of the Community.

Extending his remarks, Mr. Filosa informed the Board that Parliament had, the previous day, approved the law allowing full autonomy for the central bank in setting the discount rate.

Mr. Landau made the following statement:

The prospect of the third stage of the EMU obviously constitutes a challenge for all members of the EC. I am thus grateful to the staff for having placed a large part of its analysis of the Italian economy in this not so distant perspective. The authorities themselves have put the European integration process at the heart of their strategy, not only through the role they have played in the success of the Maastricht Summit, but also in devising--and submitting to their EC partners--a multiannual convergence program for the period 1992-94. This is indeed a major, welcome development since it commits Italy to trying to meet the convergence criteria that will enable it to continue to play the pioneering role it has always had in movements toward greater European integration.

Such a commitment, which presupposes, as the staff correctly stresses, a deep and continuous political and social consensus, will be particularly necessary since convergence came to a halt, in many respects, after 1987. This is particularly true of inflation, which remains the major stumbling block to any further sustainable progress of the Italian economy.

Indeed, even though activity in 1991 has been somewhat sluggish, the inflation differential with the three best EC performances has increased again, for the fourth consecutive year, to 3 percentage points. This relatively high level of inflation necessitates the continuation of relatively high levels of interest rates. Under such circumstances, it is no wonder that the profit margins and the competitiveness of the productive sector tend to decline. This situation also exacerbates pressures on the budget, with interest payments and wages on the rise. A sort of chain reaction is thus created which can only be stopped by a very consistent mix of macroeconomic policies. It is on this policy mix that I would like to concentrate, commenting, first, on the strong rationale behind the authorities' monetary and exchange policies and, second, on the need for further budgetary and income restraint.

On monetary and exchange rate policies, I found the staff's analysis, particularly in Appendix II (SM/92/6, Sup. 1), thought provoking. I fully agree with the conclusion contained in the staff appraisal (SM/92/3), according to which the exchange parity of the lira must remain the anchor for macroeconomic policy.

The staff clearly shows, in particular, that first, the EMS has played a key role in reducing import costs, restraining aggregate demand, encouraging restructuring, and cooling off wage claims in Italy; second, even in a context of liberalization of Italy's exchange regulations, the EMS has not resulted in a significant loss of monetary control; and third, the EMS has had strong effects on policy efficiency. Its influence on inflationary expectations may be difficult to measure in econometric terms but is amply proved by empirical evidence. The main reason for the pervasiveness of its effects is certainly related to the overall political cost of exiting and thus endangering a whole set of other, growing spheres of cooperation.

In any case, reduced or not, the EMS effect, although necessary, is now insufficient to achieve total convergence for two reasons: first, as stressed by the staff, the considerable room for maneuver which existed in the early 1980s, in terms of restructuring the Italian private manufacturing sector, has been partly used; second, building credibility is a complex and long process which involves the whole range of economic policies. It can take some time to achieve full progress in this regard.

Those reasons, and the experience of other European countries, clearly point to the need for accompanying policies which would aim at restructuring the part of the economy which deals with nontradable goods--the price of which continues to rise excessively--and, most notably, the public sector.

The provisions of the convergence program and of the 1992 budget go some distance toward this aim. Indeed, they build on tangible achievements, including a significant reduction of the primary balance deficit over the past five years.

It is noteworthy, however, that the staff's estimates point to a possible increase in the debt ratio from the current 103 percent of GDP to 112 percent within the next two years. It is thus paramount that the provisions decided by the authorities be strictly implemented. I refer, in particular, to the projected increase in health user charges, to privatization plans, and more generally, to the commitment to stick to the program objectives even in the presence of adverse developments. Strict implementation of the decisions on tax administration, tax enforcement, and bank secrecy will also be instrumental in ensuring the credibility of the authorities in the wake of the new tax amnesty.

In addition, I wonder whether more consideration should not be given to further cuts in noninterest current expenditures, which, contrary to developments in other major European countries, have risen constantly since 1985. For instance, state aid could, and certainly should, be reduced in order to return to the EC average.

There may also be a case for a temporary, further increase in revenue which would help to reduce the deficit until the necessary overhaul of the tax system produces its full effects. I refer in particular to indirect taxes, which are still substantially lower than in the rest of the EC.

It goes without saying that a major element of fiscal restraint is linked to the behavior of public wages. Indeed, it is noteworthy that the recent rise in those wages more than offset previous losses. The authorities must be commended for having renewed, last December, a policy of negotiated restraint which, according to Appendix III (SM/92/6, Sup. 1), played a significant role in the adjustment effort of the early 1980s. The return to an ex post link between inflation and public wages will certainly constitute a first step in the right direction and could helpfully be supplemented by more permanent agreements with the private sector and further progress in tax enforcement and equity. These latter elements seem preferable to imposing a prolonged constraint on administrative prices.

I would like to add some considerations on structural policies that can help trigger new gains in productivity in the economy at large, particularly the welcome and recent reinforcement of the antitrust policy and the desirability of putting greater emphasis on the restructuring of public sector enterprises. The staff's observations on compared manpower of different European public companies are significant in this

regard. I am less convinced, however, by the arguments of Appendix IV (SM/92/6, Sup. 1) on the need to alleviate the burden on the banking system because of the existence of reserve requirements. This is certainly not the time to dwell on the debate between the merits and drawbacks of reserve requirements. Suffice it to say that the argument arising from the establishment of the single market is certainly valid but pleads in favor of harmonization of those requirements, not necessarily their elimination. As a matter of fact, an Article of the Statutes of the European Central Bank, which was agreed at Maastricht, specifically provides for the possible continuation of such harmonized requirements.

This being said, Italy has proved, many times in its history, that it has the capacity to adjust quickly and forcefully to a new environment. Overall, its economic performance in growth and adjustment has been commendable during the 1980s. We are certain that in the framework now provided by the Maastricht agreement, Italy will be a strong and leading participant in the next steps toward European integration.

Mr. Goos made the following statement:

I have little to add to the staff's analysis and recommendations, and I should perhaps also refer to my statement on last year's Article IV consultation (EBM/91/11, 1/30/91), the thrust of which remains broadly valid in today's circumstances. This latter aspect is, of course, quite unfortunate, indicating that little progress has been made in the past year in tackling the most pressing problems in the Italian economy. Judging from the information provided in the report before us, it even appears that, if anything, those problems have assumed additional urgency in the wake of Maastricht.

This is not to say that the authorities had been totally inactive last year, as we are reminded by Mr. Filosa. The continued improvement in the primary fiscal balance supported by a number of corrective measures, the initiatives taken in the area of wage policy, including the suspension of wage indexation, as well as the move toward an independent central bank are encouraging cases in point; and I am particularly reassured by the authorities' commitment to financial stabilization as evidenced by the adoption of their convergence program in the EMU context.

Nonetheless, I share the staff's skepticism about the program meeting the requirements of a successful preparation for Italy's entry into the third stage of EMU--a concern which I understand has also been expressed by the OECD and EC bodies, including notably the Monetary Committee and the ECOFIN Council.

In view of the still wide deviations in Italy's economic performance from the EMU convergence criteria established for budgetary and price developments as well as for government debt, a more ambitious adjustment path than the one defined under the program would, indeed, have been preferable. In fact, even with full implementation of the program, Italy would still need to go quite some distance to realign its economy with the more stable EMS partner countries, necessitating the launching of a successor program with still quite demanding convergence tasks. There is, of course, a clear risk that such an extended process of adjustment over a period of six years will breed adjustment fatigue and eventually deprive the authorities of the opportunity to boost confidence in their adjustment strategy, which would be badly needed to contain inflationary expectations and stimulate investment activity. In this regard, I would have thought that the authorities should have aimed at more ambitious inflation targets in the first place.

These concerns are heightened by the renewed slippages in last year's adjustment targets and the disquieting fact that fiscal adjustment envisaged for this year is again based to a large extent on temporary measures. In this context, I found the authorities' observation--as cited in the report--that the fiscal convergence criteria established in Maastricht left "room for interpretation" rather worrisome and perhaps unduly complacent. While accurate in a strictly formal sense, I have considerable doubts that the attitude that seems to underlie that observation is fully consistent with the spirit of Maastricht. Moreover, I feel that the snowballing effect of the existing excessively high level of government debt, the implications for domestic inflation, external competitiveness, and growth, as well as the medium-term repercussions on the sustainability of the balance of payments noted by the staff, in and by themselves should provide sufficient grounds for the urgent adoption of vigorous adjustment policies regardless of the stringency of the existing convergence criteria.

Against this background, I take some encouragement from the renewal of the authorities' commitment, as stated in the recent Group of Seven communiqué, to closely monitor budgetary developments and to counter emerging slippages as soon as needed. Unfortunately, this commitment might soon be put to the test for the reasons I just mentioned but also as a result of the rather optimistic assumptions on future growth, export market shares, and unit labor costs in the medium-term scenario underlying Italy's convergence program.

Having said that, it appears that the credibility of the authorities' adjustment program and its prospects for success could be significantly enhanced by more vigorous supply-side measures, notably in the areas of privatization, tax reform, and reduction of government subsidies and transfers.

According to press reports, the process of privatization appears to be unduly hampered by cumbersome legal provisions, including the peculiar requirement that privatization cases must be submitted for parliamentary review if the equity stake of the state in an enterprise threatens to fall below 50 percent. An early review of the rules governing privatization would therefore appear to be appropriate.

I also encourage the authorities to pursue reform of the pension and health systems as a matter of priority. Further delays in the overdue implementation of fundamental and lasting corrections in those areas threaten to create considerable claims on the budget in the years ahead.

While I welcome the reassuring information provided by Mr. Filosa that the Bank of Italy is now authorized to set the discount rate, I had the impression that the authorities' convergence program is rather noncommittal on further specific steps to create a fully independent central bank. The adoption of a binding and more vigorous agenda of reform in that area could make an important contribution toward strengthening fiscal discipline.

Having addressed only a few selected points, I certainly do not want to detract from the critical importance of other policy areas for the success of the authorities' adjustment strategy. One such area is wage moderation, where incomes policy could make an important contribution and be supportive as a temporary device. But it is clear that incomes policy is not an effective substitute for sustained financial discipline. In conclusion, I endorse the staff appraisal.

Mr. Wright made the following statement:

I read the report before us today with a sense of deja vu, and for more than one reason. First and most obviously, the problems of convergence which Italy faces are very much the same as they were a year ago and, apart from slower growth, the economic indicators for 1991 have turned out to be very similar to 1990. Second, as I read of Italy's struggle to reduce its fiscal deficit, I was reminded of the various budget packages considered by the U.S. Congress. And third, the policy issues faced by Italy as a relatively high-inflation member of the ERM have much in common with those of Spain and, indeed, the United Kingdom.

The policy recommendations for Italy also, not surprisingly, have elements in common with each of these other countries. In Italy's case, the issues combine into a spiral of fiscal slippages, inflation in the nontraded sector, and growing lack of competitiveness. The challenge is to start the process of

convergence so as to make improvements in these areas form a virtuous circle.

The staff has laid out the issues well, and the authorities essentially agree with that view. As in the United States, there seemed to be a high level of consensus on the scale of fiscal adjustment needed. The difficulty arises in achieving sufficient parliamentary agreement on which interest groups must lose out in order to achieve this. The proposal from one quarter, for instance, to mandate the "golden rule" that the deficit be no higher than capital spending is an attempt to provide discipline, but such a rule is subject to many potential pitfalls.

In the first place, the distinction between current and capital spending is always rather arbitrary, and the effect may be to encourage public investment projects of only marginal benefit. Second, the U.S. experience with Gramm-Rudman does not bode well for the likely success of legal constraints on the overall size of the deficit; such a rule can be used as a substitute for, rather than aid to, the tough choices between individual programs which need to be made. It may also be weakened by overoptimistic forecasts of the future financial effects both of existing policy and of new measures, as, I am afraid, already seems the case from this year's budget, and by a readiness to modify the overall rule when it comes to the crunch. My conclusion from all this is that, for such a strategy to succeed, it is essential not to lose sight of the micro and administrative sides of fiscal control.

The exigencies of the fiscal position in Italy make it particularly important that the authorities stick firmly to their commitment to achieve prudent nominal fiscal targets. This, in turn, will severely limit the extent to which fiscal stabilizers can be allowed to operate. I have, in this connection, two questions for the staff. First, how much of last year's overshooting was due to cyclical factors? Second, do the estimates of fiscal retrenchment required for EC convergence take any account of cyclical factors in the period to 1995?

Looking at the composition of the budget, there are some obvious areas ripe for reform, such as pensions and health. These have been extensively discussed by the Board in the past, and action there is as important as ever. But the most striking aspect is the debt-servicing burden. It has become something of a cliché in Board discussions to say that the greater the delay in the process of adjustment, the greater the damage to the economy. But the issue of timing is particularly important in this case. The authorities must guard against any temptation to believe that delayed adjustment will be sufficient to meet the EMU entry criteria as long as the size of the debt burden is moving in the right direction by the time others are ready for the third stage. The agreed convergence criteria are, of course, minimum standards.

The dynamics of interest costs mean that early adjustment will be particularly important in stabilizing and, more important, reducing the debt/GDP ratio. Obviously, the long-anticipated achievement of a primary surplus will be most effective if it takes place before the interest burden is increased further. But in the current situation of rough primary balance, the direction of change in the debt/GDP ratio also depends on the relative figures for real interest rates and real GDP growth, or the "inertia factor" as it is described in the background paper. The real interest rate, which reflects the premium on government debt, can be mitigated by a reduced level of borrowing through early adjustment, and a more credible longer-term debt reduction strategy will help by reducing the market's expectations of future borrowing, by allowing a recovery in the credit rating, and by forestalling potential strains on the exchange rate. The events of late last year showed how quickly lira weakness can add to the Government's financing costs.

The potential benefits which I have described will apply whatever the maturity of debt issued. But I would be interested to hear from the staff or Mr. Filosa whether the authorities have given any consideration to the appropriate time to seek to lengthen the maturity of the debt structure. There are several reasons why this lengthening would be a desirable end in itself for debt-management purposes. I note that the yield curve seems to be only modestly negative at the moment. It could become more markedly so, however, in response to a more consistent and credible effort to tackle the deficit. This could have a significant bearing on the most suitable timing of any restructuring.

I welcome the news that Parliament has passed the Privatization Bill, and I urge the authorities to implement it rapidly. As my own authorities have found, a vigorous privatization program can achieve an immediate reduction in government debt, but it can also help to address the problems of nontradables, inflation, and competitiveness. The dissatisfaction with the quality of public services, entry barriers to the services sector, and the pervasive role of public enterprises in manufacturing all suggest that there is considerable scope for the removal of structural rigidities and the exposure of a wider sector of the economy to the disciplines of ERM membership. The opening of the service sector to foreign competition, as recommended by the staff, would in effect roll back the frontiers of the nontradable sector and reduce the strain on manufacturers' margins.

On the contribution of wage restraint to the convergence process, I support the staff's caution over the merits of national wage agreements, especially if they can be achieved only at the expense of fiscal concessions. The extent of government

intervention would most appropriately be confined to setting a firm example, as the latest budget does, through public wages, and bolstering the credibility of the Government's anti-inflation policy. The fiscal costs of real reductions in administered prices must be carefully considered. I recognize that a move toward regional wage differentials might result in continued depopulation of the South, but this danger would, arguably, be even greater if labor costs which are out of line with productivity mean that businesses close down there or locate elsewhere. Structural reform and development of work force skills must be a more appropriate response to the long-term problem than the tax on industry represented by artificially boosted wage levels.

As to the relationship between domestic monetary and exchange rate policy, first, I would seek to qualify the staff's assertion that the exchange-rate focused policy is unbalanced and costly. While this is correct, it is emphatically not a shortcoming of the exchange rate policy per se but a reflection of the failure to come to grips with the debt burden and rigidities in the non-tradable sector. The exchange rate policy is invaluable in bringing these other problems into sharp focus.

Second, the staff mission wondered whether, with the lira credibly positioned in the middle of its band, monetary policy could make much additional contribution to the fight against inflation. The answer is, of course, that an insufficiently tight fiscal policy, interest rates close to those of the countries anchoring the ERM, and a currency credibly in the middle of its band is an unsustainable long-term combination of events. Unless market confidence in the anti-inflationary thrust of fiscal and other domestic policies is increased, the likelihood is, as we saw late last year, that there will be occasions when interest rates will have to rise relative to those in ERM partners in order to sustain the currency.

An unfavorable analogy is drawn with the tight monetary policy followed by the United Kingdom in the early 1980s. This involved a substantial and rapid nominal and real appreciation of sterling versus the rest of Europe, an option which does not seem viable for Italy within the progress toward EMU. For this reason, I do not regard the analogy as a very valid one. But even so, looking over the 1980s as a whole, I do not think we would see our actions--which represented a marked change in economic policy--as having had medium-term costs in terms of output and employment at all; quite the reverse, in fact. The important thing was to act promptly to restrain inflationary pressures and to persuade economic agents that the authorities meant business.

Mr. de Groote made the following statement:

Economic policy in Italy seems to be paralyzed, at least in terms of public opinion, by the widespread acceptance of three myths. The first is that the public deficit does not matter all that much, for the following reason: after all, the dynamism of the private sector is very obvious and stems partly from the low rate of effective taxation on real income, which is actually much higher than the statistics indicate. This is probably the most dangerous of the three myths. The second myth is that the EC will somehow turn out to be a miraculous catalyst eliciting from government, public opinion, and the social partners a quick adjustment of costs. The third myth, prevalent in the academic community, is that Italy's successes since World War II have to some extent resulted from Italy's always having been able to correct the exchange rate in time to wipe out comparative cost disadvantages. Now the constraints imposed by integration into the EC require seriously reducing expectations that much success will flow from new miracles. Indeed, the assessment of Italy's current performance, judged on the basis of what should be done to conform to EC norms, is far from satisfactory in many respects. There are, of course, some indications that the convergence process has started in some areas of the economy, and there are some welcome policy decisions, but the most realistic expectation is that the convergence criteria will not be met on schedule, and perhaps will not be met at all. In my view, the key element in this situation is the present stance of fiscal policy, which not only underlies the high levels of the budget deficit and the public debt that are the major obstacles to meeting the convergence criteria, but is also the general cause of the economic paralysis which frustrates the effort to implement economic policies.

The deviations of the GNP ratios of Italy's public debt and public deficits from EC convergence criteria are not the only reason Italy's fiscal imbalances should concern us. They create additional problems in the form of persistent pressures on inflation and interest rates, and the latter are now also far out of line with the convergence criteria.

Since elections are upcoming in the spring and it is probable that a new government will be formed about midyear, I have decided to confine my reflections to analytical topics without attempting to address immediate policy issues, since in any case the new government will have to review its policies sometime in the summer or fall. I will deal with four general analytical subjects: first, the snowball effect of the public debt; second, the limited effectiveness of the measures now planned; third, the effect of the deficit on infrastructure; and finally, the relationship of the deficit to inflation and to the noncompetitiveness of the services sector.

Our main concern in connection with the current high level of public debt is its self-reinforcing character. Even if fiscal policy should manage to more or less balance the primary budget, this huge stock of public debt will push up interest rates, and the higher interest costs will add further to the stock of public debt. As interest rates rise and GDP growth falls, which is the normal result of high budget deficits, the snowballing of debt becomes more likely; Belgium had a similar experience, and we know this situation well. In addition, since rational forecasting takes account of the interest rate sensitivity of debt-service costs, the existence of a large stock of public debt can create expectations that fiscal policies will change abruptly in attempts to offset these effects with one-time measures. In fact, about 60 percent of Italy's most recent package of measures consisted of one-time measures. In other words, this situation contains an incentive to substitute discretionary measures for fundamental reforms.

On my second point, it does not appear to me that either the budgetary policy measures introduced in 1991, or those planned for 1992, will suffice to change the fiscal position very much; as noted by the staff, this is partly because the measures are not permanent. The targets for stabilizing the public debt/GDP ratio assume that macroeconomic developments will be favorable, but it is clear from the discussion in Appendix I (SM/92/6, Sup. 1) of medium-term developments that there is a significant risk that these targets cannot be met. The different scenarios in the Appendix show that successful implementation of the planned adjustment measures is crucial for meeting the fiscal targets and that fiscal policy must therefore intervene more actively. To reverse the rising trend of public debt as a percentage of GDP, both the level and effectiveness of public expenditure must be addressed. The fact that Italy's tax revenue/GDP ratio approximately equals the EC average, although its tax rate is far above the average EC rate, suggests that there is room to improve revenue collection. Without even considering the possibility that the same amount of tax revenue could be obtained with a lower tax burden and a less distorting tax structure, it is clear that correction is needed in this area.

Third, a further disadvantage of high public debt is that if budget revenues remain constant, the only way of paying the high interest rates on public debt is to reduce expenditures in other areas like infrastructure. The crowding out of other expenditures by the interest costs of public debt causes the infrastructure to deteriorate and greatly lowers the efficiency of capital. The staff has rightly noted complaints about the quality of Italy's economic infrastructure which also seem to bear out this concern.

Concerning the relationship between the deficit and inflation, it is obvious that Italy's poor budgetary performance

is the principal cause of another major symptom of the economy in recent years--its high inflation rate compared with that of other industrial countries. It is true that inflation declined significantly during the 1980s. At the same time, the economy was being opened up, the balance of payments transactions of the capital account were being liberalized, and the lira was making its entry into the EMS, developments which have altered Italy's options for conducting macroeconomic policies. Now, given Italy's historically high inflation, the entrenched inflationary expectations, and the limited room for reducing inflation differentials through devaluation, there is a real danger that efforts to stabilize the lira in relation to currencies with lower inflation rates will continue to push up the cost of servicing the public debt and become a kind of embedded source of continued imbalance.

The staff correctly stresses the danger posed by sheltering the services sector from competition, which makes it possible to pass on any increased cost into prices. This contributes not only to inflationary pressures but also to a constant misallocation of resources in the economy. As long as profits are shielded by monopoly from competitive pressures, there is no incentive to strive for more efficient resource allocation. The staff is especially correct in emphasizing that in this area, monetary and exchange rate policies have only a limited usefulness against inflation, and that increasing exposure to competitive forces would be more effective than restraining incomes. I would like to balance this view somewhat by pointing out that instead of relying only on stronger competitive forces, as described and recommended in Appendix II (SM/92/6 Sup. 1), still greater advantages could be obtained if the forces of competition were reinforced by certain measures which cannot accurately be classified as incomes policies. These would be measures establishing, in the area of wage determination, some sort of anchor providing a regulator, reference, and framework for the social partners. The "competitiveness norm" introduced in Belgium in 1982 has turned out to be extremely useful as an anchor to the behavior of the social partners. Of course, I fully agree with Mr. Goos that incomes policies can never be a substitute for sound policies, but they can certainly be useful for reinforcing sound policies and as an incentive for implementing sound policies. But let us take care not to overuse the term "incomes policy," because in fact we have in mind not a constraint imposed by the Government on income determination, but a guideline providing a strong economic basis for recommendations in that area.

Let me conclude by expressing the wish that Italy will soon have a government that will be in a position to implement a credible policy enabling this country, with its usual resilience, to once again assume a leading role in European integration.

Mr. Tabata made the following statement:

At the time of the previous Article IV consultation discussion on Italy (1/30/91), I commented: "It is worth discussing whether a country with limited flexibility in fiscal policy, rigidity in real wages, and a commitment to peg its currency to other strong currencies within a narrow range, thereby curtailing monetary autonomy, can attain a favorable economic situation." One year has passed since then, and the economic situation has deteriorated further. Real GDP growth, inflation, the unemployment rate, the general government deficit, and public debt have been far worse than the average for EC countries.

On the fiscal front, the government deficit as a percentage of GDP is projected to be 8.4 percent in 1992. However, according to the staff's analysis, the 1992 budget is based on underestimation of the trend deficit, overestimation of revenue, and a higher growth rate than expected. In addition, approximately one half of the increase in revenue depends on once-and-for-all measures. Under these circumstances, it is urgent that the authorities make every effort toward fiscal consolidation, such as exercising restraint in public sector wages, freezing employment, reducing health expenditure, and reforming the pension system. Unless the authorities implement these streamlining measures, public debt, which was already 103.8 percent of GDP in 1991, will accumulate, interest payments relating to the public debt will increase further, and ultimately this will have an extremely bad effect on the economy.

On incomes policy, as the staff analysis made clear in Appendix II (SM/92/6, Sup. 1), wage restraint in both the public and private sectors is critical to stop the acceleration of inflation. The authorities made efforts to restrain public sector wages; therefore, it is imperative to establish a credible relationship between employers and trade unions to set wages within an increase in productivity.

As for monetary policy, I welcome the fact that the Bank of Italy has been authorized to set the discount rate and that monetary financing of the government deficit is prohibited. This is a normal responsibility of an independent central bank and constitutes a big step toward speeding up establishment of the European central bank. However, these reforms did not provide the Bank of Italy with a wider range of policy implementation under the current circumstances. In fact, when the Deutsche Bundesbank raised its discount rate in December 1991, the Bank of Italy was obliged to raise its discount rate so as to maintain the lira rate against the deutsche mark, even if the domestic economy was stagnant. The room for maneuver of monetary policy is extremely limited.

With respect to exchange rate policy, I support the authorities' intention to maintain the parity of the lira rate in the ERM as the anchor for adjustment of other economic variables. However, as I pointed out at the Board's informal discussion on exchange rates and interest rates, unless German interest rates decline in the near future, it would be worth considering realignment of the ERM currencies. This would broaden monetary policy's room for maneuver.

Finally, one of the critical needs of the Italian economy is to increase productivity. Consequently, it is urgent to increase capital and equipment investment at high-technology levels. In this context, I would like to ask what practical measures to increase capital and equipment investment did the staff recommend to the authorities?

Mr. Posthumus made the following statement:

The staff report for the Article IV consultation with Italy is particularly important because the staff has assessed the economy from the perspective of Italy's joining the EMU by the end of this decade. Mr. Filosa has indicated the preparedness of his authorities to face the challenge of discussions in the Fund on the adjustments necessary for Italy to achieve the targets set by the EC. Indeed, as he says, Italy holds a significant share of the responsibility for the successful completion of monetary unification. I hope that the Board will also be able to rise to the challenge and appraise, frankly and critically where necessary, Italy's efforts, and of course the efforts of the other EC members in forthcoming Article IV consultations. This would be an important and valuable contribution of the international community to its European members. It would also be a contribution to Italy's policies themselves--policies which Italy would have to undertake anyway.

The nominal convergence criteria which were agreed upon at Maastricht have been designed as numerical criteria. My Netherlands authorities have noted with concern that the Italian representatives indicated that there was room for interpretation of the fiscal convergence criteria, which should not be viewed as strictly numerical criteria, according to the staff report. I also note, however, that Mr. Filosa has not made such a statement.

The fiscal targets of Italy's convergence program are considered to be the minimum necessary for 1994, and further progress would be required to put Italy fully on course for the EMU. We attach great importance to the fact that the Italian Government has committed itself to deficit targets expressed in absolute lira amounts. The staff's calculations of the budget deficit under a high- and low-growth scenario, assuming no further

adjustments in addition to the 1992 budget, indicate that in 1993 and 1994 substantial additional measures are required. In fact, these calculations show that the trend of the deficit will not be broken in 1992.

If then the targets for 1992 would not be attained, and there seems to be a risk that this would be the case, the tasks for 1993 and 1994 would become even larger. Could the staff comment on the practical possibility of taking further measures this year which would guarantee attaining the 1992 deficit target, and perhaps even improving on it? The supplementary information we received indicates that such measures may indeed be required. Is it likely, and feasible, that a law can be enacted limiting budget deficits to net government capital expenditure? What would the budget deficit be in 1992 if such a law were in place now?

Although monetary policy is constrained by participation in the narrow ERM band, there still exists some leeway for using the interest rate instrument, even if the lira is not under pressure. As long as credit to the private sector continues to grow by 15 percent a year, and the money stock grows by more than 8 percent a year--with a targeted range of 5-8 percent--the goal should not be to reduce interest rates or the differential vis-à-vis German interest rates, but to continue a tight monetary policy to signal to the markets, the employers' organizations, and the trade unions that reduction of inflation has priority. More generally, we would appreciate more attention by the staff to the conduct of monetary policy within the constraint of the narrow band. For instance, excessive domestic money creation in ERM countries could accommodate gross capital outflows to countries like Germany, complicating monetary control in the "anchor country" of the EMS. Finally in this connection, we welcome the fact that the Bank of Italy has assumed formal power over setting the discount rate. In our view, this is an important contribution toward strengthening the coordination of monetary policy in the second stage of the EMU. The next step is to terminate the Government's credit facility with the Bank of Italy.

In his statement, Mr. Filosa observed: "The Italian economy is strong enough to achieve the targets set and to sustain the inherent transitional costs." I cannot agree more, largely because I believe that reducing a budget deficit does not reduce economic activity--or if so only very temporarily--but does rather enable the market forces to increase investment and consumption expenditure. I support the staff's appraisal explicitly. Perhaps the Chairman could meet the new Italian authorities at an appropriate moment to bring the message of this appraisal to their attention.

Mr. Dawson made the following statement:

A year ago we pointed to the basic incompatibility between Italy's persistent fiscal laxity and the financial discipline necessary to adhere successfully to a fixed exchange rate regime. Today, as the staff questions the very sustainability of Italy's exchange rate policy, we find ourselves ironically half hoping that participation in the EMS might be effective as the only means of forcing the needed structural transformation of the economy. However, our view is based less on the economic effects of a fixed exchange rate policy than on the political necessity of reaching certain economic targets.

It is not difficult to imagine a gloomy medium-term scenario along the lines of that projected by the Fund staff, given not only current trends but also past experience in Italy. Still, notwithstanding the current weakness of the economy measured by growth, the current account, and inflation, as well as the underlying vulnerability of Italy's financial market, the high level of government debt, and the capital account, Italy continues to stretch the boundaries of what we might theoretically consider an "unsustainable" economic situation. Despite year after year of Cassandras--including at the IMF, the OECD, and the EC--predicting the implosion of the Italian economy, it continues to sputter along even in the worst of times, largely owing to the imagination and creativity of the private sector.

We tend to be of the school that believes fundamental change will not take place in Italy until a crisis situation exists. And it has become clear that the crisis--or at least one of proportions that will be necessary to force major change--is not likely to come from pressures within the economy. As an example, we need only observe that the current broad domestic reaction to the feeling that the lira is overvalued has been manifested most strongly in a push for devaluation rather than a popular call for fiscal tightening and a return to sharper incomes policy.

Instead, the crisis is more likely to be provoked from abroad--although not in the immediate future--a possibility the staff itself raises, in the form of the political necessity of meeting the EMU criteria. At some stage there is likely to be a faceoff between those policymakers willing to risk the credibility loss of a change in the exchange rate or even potentially dropping out of the EMU schedule--assuming it continues to move forward on its current timetable--in order to keep their pockets of domestic influence, against the more responsible types in the economic ministries and the Bank of Italy intent on economic stabilization. As a result, the discussion has now shifted from whether "unsustainable" economic conditions exist in Italy to whether convergence with EMU standards is possible. At this point, it is not clear what the outcome will be.

Looking at the financial situation more closely, the fiscal problems seem to be caused by chronic excessively optimistic official growth and inflation estimates in calculating the budget, which result in overstated revenue projections; too many--50 percent according to the staff report--one-time deficit measures that do not address structural problems; and the success of special interest lobbies in convincing Parliament to amend spending bills. There are already reports of expected revenue shortfalls and new expenses in the 1992 budget that will make the deficit 1.4 percentage points higher than now projected--bringing the deficit to 9.8 percent of GDP--not including the potential shortfalls owing to the smaller than hoped for privatization gains and the uncertain effects of the tax pardon, both mentioned in the staff report. Those areas most in need of severe reform action--specifically the health and pension areas--are virtually untouched in the current budget, and the modest measures that were included have already been partially undone. We strongly agree with the view that the Government's economic authority would be greatly enhanced by the ability to make binding administrative decrees on economic issues. Indeed, in that regard, the comment by Mr. Filosa that the Treasury strongly holds the view that constitutional amendments that raise the powers of Government relative to those of Parliament in matters concerning the budget are crucial to the effective implementation of the fiscal plan strikes a welcome chord both for my chair and I suspect for Mr. Kafka's chair as well.

It is also clear that monetary policy is becoming increasingly unable to address the high inflation and fiscal weakness problems, as is evident in the waning effectiveness seen in directing market interest rate responses. It is difficult to expect the Bank of Italy to do more than the heroic efforts already made, but the question should be at least raised as to whether it is possible for the Bank of Italy to take a tougher stand in principle. The tenth anniversary last year of the "divorce" between the Bank and Treasury's automatic financing ability marked the basic independence of the Bank of Italy. But there are some that say that the marriage has only been replaced by a concubinage. Legislation has only recently been introduced that might finally remove the remaining automatic advances to the Treasury--even if they have largely been kept to a minimum--as required by the second stage of EMU convergence. Furthermore, money growth targets are still based on official estimates of inflation and the Treasury's borrowing requirement.

The pact between the Government, trade unions, and industry is a positive development insofar as it grants some breathing space before resolution of the wage issue. Still, even in its current form, it is not clear that the Government's side of the bargain will be fiscally neutral, given the promises on administered price increases and social security payments. The staff

is convincing in its argument that renewed tough incomes policy is necessary for sustained improvement in competitiveness and to meet the short-term inflation targets for EMU convergence. In addition to capping wage increases and freezing public sector employment, we would argue for complete elimination of the indexation system.

The staff discussion on disinflation over the past decade raises some rather interesting angles to the exchange rate policy question. In fact, it makes clear that exchange rate fixity on its own is not sufficient in curtailing inflation, but of necessity it must be supplemented by other appropriate economic policies. One might conclude that the particular exchange rate regime is less important than the fact that it be nominally stable and backed up by appropriately tight financial and structural policies--a point that could be universally applied. In any case, the staff concludes that the EMS has already forced tougher policies on Italy that might not have otherwise been politically possible, and this, not the direct economic effect, appears to "have been the main merit of the EMS." In other words, the discipline of surveillance enforced by sanctions, in this case political, which could as well have taken place under other umbrellas--such as the OECD or smaller groups like the Group of Seven--would have had the same beneficial effect.

Finally, I would like to reiterate our long-standing views regarding the continuing need for increased domestic and foreign competition, particularly in the nontradable goods sector, where inflationary pressures are the strongest. Simplifying the current tangle of regulations and licensing requirements would improve transparency and reduce the scope for non-market-oriented business methods and transactions. Additionally, steps should be taken to encourage rather than limit foreign investment.

Mr. de Groote commented that the appendices (SM/92/6, Sup. 1) prepared by the staff--notably Appendix III on wage indexation and labor costs--should be given a more public forum and in that way help the authorities in formulating Italy's program. The staff's observations were useful; for example, Appendix V concluded that a strategy of constantly trying to maintain capital inflows through high interest rates could be pursued only to a limited extent and that the answer was to shift exchange rate expectations downward.

Belgium's situation was similar in many ways to that of Italy, and, therefore, he suggested that, like Belgium, Italy consider a shadow program with the Fund, Mr. de Groote added. Without applying for Fund resources, Italy could submit policies to the same criteria as a Fund-supported program and maintain a dialogue with the Fund so as to formulate a credible program. The procedure was proving to be very useful in Belgium during the process of forming a new government. Similarly, the Fund could assist the Italian authorities in building up public support.

The Director of the European I Department said that the appendices prepared by the staff would be issued in the Fund's Working Paper series. Meanwhile, the Italian authorities were well aware of the reform measures required and were attempting to overcome political opposition to their implementation.

On monetary policy, the reserve requirement had been established to offset the large recourse of the Government in the past to the central bank, the Director remarked. The requirement constituted implicit taxation to finance the Treasury; in an efficient system, taxation should be explicit. Also, the reserve requirement would place the Italian financial banking system at a disadvantage once the single market for financial transactions was in place. Therefore, harmonization would be important, although it would be difficult to achieve; some countries had a zero reserve requirement, while Italy's amounted to about 22.5 percent.

The independence of the central bank had been strengthened by recent measures, but he recalled that former U.S. Federal Reserve Board Chairman Volcker had referred on several occasions to the influence and independence of the Bank of Italy, even when those attributes were not part of its statutes, the Director continued. Because of the high qualifications of its staff, the central bank played an important role in analyzing and formulating economic policy and thus in influencing public opinion. The staff was undertaking all the measures required to meet the objective of central bank independence by the second stage of the EMU.

Meanwhile, there were limits to the independence of the monetary authorities in the system itself, including with respect to gearing the interest rate to domestic objectives, the Director noted. For example, when those objectives conflicted with external objectives, it was difficult to simultaneously maintain high interest rates and control the money supply. Indeed, in a system like the EMS, only one country could do so while the others, which might have those targets ex ante as an indication of their strategy toward inflation, would ex post have to act on the interest rate on the basis of exchange rate considerations rather than of the money supply. If there was a conflict, exchange rate considerations would prevail.

Additional measures equivalent to 1-1 1/2 percent of GDP would be required to achieve the budgetary targets, as indicated in the staff report, the Director stated. The growth projections on which the budget was based were more favorable than the likely outturn, and some measures might not produce the desired effect. The Italian Government had in the past adopted packages during the course of the year to achieve the fiscal target, according to developments in the economy, and it would not be surprising if it decided to adopt additional measures during 1992. An important question was the timing of the elections and formation of the new Government, which could delay adoption until the beginning of the summer. The staff hoped that, meanwhile, constraints on spending would be maintained.

If a law were enacted that limited budget deficits to net government capital expenditure, it would imply that the 1992 deficit would have to be

less than half the present level, the Director said. Of course, such a law was not part of Italy's statutes, although it had been proposed by the Chairman of the Senate Committee.

Nearly all of the overshooting of public finance targets the previous year had been due to the cyclical component, the Director commented. However, the problem with automatic stabilizers in Italy was that the starting point was a difficult one in terms of both the size of the deficit and the size of the public debt. Therefore, the staff welcomed the authorities' intention not to use the automatic stabilizers in the coming year but to stick to their target in absolute amounts, rather than as a percentage of GDP or on a cyclically adjusted basis.

The GDP growth rates implicit in the convergence program--2.5 percent in 1992, 3.2 percent in 1993, and 3.5 percent in 1994--indicated a relatively strong performance and were rather high compared with World Economic Outlook projections, the Director noted.

The final version of the Privatization Bill, which had been approved by Parliament, indicated that the authority to decide on privatizations rested with the Prime Minister, the Director stated. While Parliament might express views on the matter, it did not have the authority to approve or refuse decisions on privatization.

It had been suggested to the authorities that, at least on a temporary basis, incomes policy would be a useful instrument, the Director reported. In that connection, in the mission's concluding statement, the staff had noted that the Italian authorities could draw on the Belgian experience with respect to the budget and competitiveness. However, as stated in the report, no final decision on incomes policy had been taken, and negotiations between the social partners were continuing.

The staff, because of its lack of expertise in the area, had not made any precise suggestions on investment that would improve productivity through innovation and technological improvement, the Director of the European I Department remarked. Instead, the staff had called for an improved general environment for investing, which could best be achieved by lower interest rates after inflation convergence, by a more efficient market, by increased competition, and by policies that would eliminate the inefficiencies that remained in the government and tertiary sectors and thus reduce the burden on the productive sector.

Mr. Wright wondered whether the authorities had considered the possibility of lengthening the maturity of the debt structure. Risk management of debt could argue for such action, although cost could argue against it at the present time because the markets had not yet given a vote of confidence to the fiscal strategy, as reflected in the yield curve, which was barely negative.

The Director of the European I Department explained that, with improved inflation expectations, the Italian authorities had been able to lengthen

the maturity of the debt and to sell at a fixed interest rate, rather than under variable interest rate conditions. However, the margins existing in the intermediation of that debt were high by international standards, and there was room to reduce those margins by improving competition and efficiency in the institutions that marketed government debt. Nevertheless, doing so would not be a substitute for implementing the fundamental adjustment measures that were required.

Mr. Posthumus asked whether the staff could comment further on the conduct of monetary policy within the constraint of the narrow band of the ERM. It might be useful to look at interest rate policy within the constraint of the narrow band and not move too quickly to lower interest rates, if only to signal to the market that the authorities gave high priority to addressing inflation.

The Director of the European I Department commented that the staff would study the matter further. Long discussions within the EC had led to the Basle-Nyborg Agreement on more flexible use of the interest rate within the band, and in fact on more flexible use of the band itself. But the fundamental point, which the staff had discussed with the authorities, was the role of monetary policy, given the constraints imposed by the ERM. During the discussions, the staff had indicated to the authorities that other countries had used monetary policy more aggressively. The authorities had replied that doing so would imply exchange rate appreciation not only in real terms but also in nominal terms, which would not be credible in the market, given the inflation differential, and would therefore have to be reversed, contrary to the agreement to maintain exchange rate stability among the partners.

The authorities could not act on the basis of the money supply target, because only one country could do so in the EMS, the Director added. Otherwise, the system would be indeterminate. The staff would look into the issue, noting the experience of all participants, including those which used interest rate policy but which did not take into consideration monetary aggregates.

Mrs. Sirivedhin made the following statement:

> After relatively favorable achievements in the past few years, and considering the excellent potential of the economy, Italy's economic performance in 1991 has been on the whole rather disappointing. While external factors were at least partially responsible, shortfalls in some areas of policy implementation also played a role. With developments toward EC economic integration proceeding at a brisk pace, Italy can no longer afford further delays in addressing the main issues of the fiscal deficit and inflation.
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> Like other Directors, I welcome the three-year Fiscal Plan, which is an expression of the authorities' determination to tackle the fiscal situation. Although I would have preferred a more am-

bitious timetable, in order to reduce more rapidly the interest rate burden, it represents a major step in the face of considerable constraints. Since the tax incidence in Italy is already very high, the revenue side should emphasize implementing tax reform, broadening the tax base, and reducing evasion. More should be done to trim outlays, especially wages and social expenditures. The decision to limit wage increases to the target rate of inflation is welcome. Unemployment benefits appear to be very generous and could perhaps be reassessed. More generally, it may be advisable for annual budgets to be as a rule more conservative in revenue estimation, so that the risk of underperformance will be minimized.

Labor costs in general need to be contained in order to reduce inflation, improve export competitiveness, and encourage investment. A firm policy to restrain incomes is crucial, and I welcome the steps being contemplated. The slackening off in 1991 of the declining trend of unemployment in the South is unfortunate. Based on the presumably lower cost of living in the South, I continue to feel that some wage differentiation, together with measures to attract investment to that region, might be useful. This should in the long run lead to declines in regional disparities.

Italy's trade with developing countries is less than 20 percent of total trade, even when OPEC trade is included, and I hope that this can be expanded in the future. I commend the authorities for their continued efforts to provide official development assistance to developing countries. I hope that the dip in 1991 is indeed temporary, as stated by the staff.

Mr. Végh made the following statement:

The Italian economy is certainly at a crossroads. As one of the founders of the EC, it may be assumed that Italy will continue to be one of the main partners of the integration process. However, the conditions recently set to become part of the EMU have made Italy's chances in that respect questionable.

Italian inflation and public debt levels are much higher than the limits recently established. I would like to comment on these two problems, but first let me state that I do not see any alternative for Italy other than a full-fledged program of privatization.

It seems that the nominal anchor represented by the exchange rate policy has not been able to reduce the inflation differential beyond a certain level, although it has helped to bring down the aggregate inflation level. Monetary policy is limited, in turn, by the exchange rate policy; that is, it cannot be as restrictive

as necessary to lower inflation without the risk of bringing the value of the lira below its lower margin. Moreover, to rely on high interest rates to fight inflation would have counter-productive effects on the fiscal outturn. As to incomes policy, I doubt that it can provide lasting results; its beneficial effects are of a short-term nature. This is, of course, when incomes policy does not behave as a direct impetus to inflation through excessive wage increases. The only sustainable way to increase salaries and profits is through increased productivity, and the only way to abate inflation is through increased competition. However, nontradable goods are, by definition, not subject to external competition, and I would appreciate comments from the staff on possible ways to solve the problem of inflationary pressure stemming from the nontradable sector.

As to the high level of public debt, I recall from the 1990 Article IV consultation discussion (1/30/91) that the 100 percent debt ratio was apparently as high as it would grow and that it would soon start falling. We now have similar projections for the decline of the ratio, but of course the turning point will be reached at a higher debt ratio. As I mentioned in my statement on Brazil, the interaction between the rate of growth of the economy and the interest rate becomes a crucial element in the analysis of the sustainability of a given level of debt. It is noteworthy in this respect that of the main components of growth of the debt ratio--an increase of 3 percent of GDP between 1990 and 1991--that is, the primary deficit and the inertia factor, the latter is more important.

Being an increasing function of the differential between the interest rate on debt and the GDP growth rate and of the size of the debt, the inertia factor points to the critical importance of the rate of growth. Italy is already facing a vicious circle in which the unpostponable adjustment of the fiscal accounts will unfavorably impinge on the rate of growth, which, in turn, will strengthen the importance of the inertia factor in the growth of the debt ratio. This situation is further complicated by the recessive trend of the world economy and by the relatively high level of interest rates stemming from the German economy, compounded by the increasing country risk element of the Italian economy.

As to adjustment of the fiscal accounts, in spite of having financed the budget with a great deal of reliance on debt financing as opposed to tax financing, fiscal pressure in the Italian economy is not much lower than that in its EC partners. That is, although there is still room for increasing fiscal revenue through better fiscal administration, the thrust of the adjustment should come from the expenditure side of the budget. In this connection, I have doubts, rising from the political constraints facing the Government, that it will be feasible to

reduce expenditures in the amount necessary to overcome the influence of the inertia factor mentioned earlier. Political costs will be inevitable, but the greatest returns from those costs would come from a well-formulated, full-fledged program of privatization. This will not only strengthen the fiscal account but help to boost the productivity of the Italian economy, a factor which is becoming crucial to the sustainability of the current account deficit. Moreover, once the privatization process is under way, it will be much easier to pursue the necessary structural changes in expenditures in the areas mentioned in the staff report, such as health and social security.

I would like to mention the positive sign given by the Italian authorities in opening the Italian market to imports from Eastern European countries and the former U.S.S.R. This is precisely the policy response that those countries are expecting from the West, namely, not only financial support but also market access. I congratulate the Italian authorities on this policy.

The fiscal situation was critical, Mr. Végh added, and present data were disappointing. If the main parameters were given likely values, the conclusion was that Italy was far from the solvency required by convergence. While Mr. Wright had argued that it might be worthwhile to lengthen the average maturity of public debt, he himself was not sure that a decline in the proportion of treasury bills and an increase in medium-term and long-term securities would be cost effective. The real interest rate would be rather high in the EC, and in Italy in particular, because of the Bundesbank rate, which was the implicit anchor of the EMS. In that sense, the fiscal deficit was a reaction also, because the fiscal deficit in Germany forced the Bundesbank to raise interest rates and, in turn, Italy, under the EMS, had to keep pace with the German rate. Significant progress was required to meet the tight Maastricht Treaty timetable so that Italy could participate fully in the monetary union of the EC.

Mr. Wright said that a general principle of debt management was the lengthening of the debt maturity. However, he agreed with Mr. Végh that, looking at Italy's yield curve and considering the cost involved, the application of that principle in the present situation was questionable. Obviously, the authorities would benefit doubly from introducing a more convincing fiscal package: the direct fiscal benefit, and the effect on market expectations and the yield curve, which would provide a cost advantage to lengthening the maturity of the debt.

Mr. Posthumus commented that he was not fully convinced by Mr. Végh's remark about the effect of the increase in the German deficit on other deficits in the EC. If other countries in the EC had high deficits and/or high debts, then any increase in interest rates had the effect of increasing the deficit, irrespective of German policies.

Mr. Kafka made the following statement:

Despite remarkable strides made by the Italian economy in many respects, the reduction of the fiscal deficit must be the centerpiece of the authorities' macroeconomic policies, particularly in light of the high debt burden and the targeting of fiscal and inflation convergence as part of the thrust toward economic integration by EC members.

We, therefore, commend the Italian authorities for having concluded that, beyond temporary measures, they will seek to introduce more permanent measures in fiscal years 1993 and 1994. There have been many suggested structural reforms with respect to health care services, pensions, and the delegation of fiscal authority to local government bodies. These suggested reforms would go a long way toward addressing the current fiscal imbalances and facilitating fiscal convergence. In this context, we also welcome the recent passage of the Privatization Bill. Clearly, the sharp increase in real wages in the public and private sectors in recent years, coupled with decelerating productivity growth, have spurred inflation and impaired competitiveness. Efforts to control inflation and improve competitiveness are currently constrained by what we perceive as rigidities in the labor market. The tendency toward centralized wage bargaining, while there exist productivity differentials between regions and sectors, can distort the labor market. In addition, employment subsidies to firms as well as restrictive practices in the services sector further distort the labor market. The authorities will need to implement structural reforms to control these rigidities. We hope, however, that the authorities will succeed in maintaining the deindexation of wages.

The cautious monetary policy pursued by the authorities has achieved exchange rate stability. We welcome the introduction for the new system for minimum reserve requirements and the fact that the authorities will continue to announce money supply objectives on an annual basis in the hope of influencing market expectations. In addition, the move toward establishing greater independence for the central bank of Italy is also highly commendable.

I share the view of Mr. Filosa that the Italian economy is strong enough to withstand the transitional costs associated with adjustment and with his authorities' commitment to achieving the agreed targets for convergence.

Mr. Monyake made the following statement:

Italy's commitment to full participation in the EMU, scheduled to enter its second phase on January 1, 1994, has imposed the obligation to meet specified convergence criteria of

economic performance, just like other members. Achievement in the exchange rate and monetary policy areas has, since January 1990, been commendable, although it has been accompanied by high real rates of interest and wide fluctuations in short-term rates. Efforts to meet other specified criteria, however, faltered as the deficit level, debt ratio, and inflation rate exceeded their respective targets by substantial margins. The weakening of growth and export performance has further worsened the situation.

In general, I concur with the staff appraisal, and I urge the Italian authorities to consider strengthening current policy measures and to adopt other strategies proffered by the staff to correct existing imbalances and strengthen the economy's growth and export performance on a sustainable basis. Of major significance are the fiscal and structural measures which should complement the current monetary and exchange rate policies. Notably, a timely implementation of structural measures, including tax reform, price liberalization, and privatization, as well as the adoption of a comprehensive labor market reform, would facilitate the required fiscal consolidation, raise productivity gains, and enhance the competitiveness of the economy. The authorities' strong commitment in this regard, described by Mr. Filosa, is reassuring. In addition to any other measures that may be contemplated, the authorities should take steps to ensure a reduction in the pressures on interest rates, as the prevailing high real interest rate level has, apart from constraining output growth and fiscal adjustment, also imposed an additional burden on many developing countries indebted to Italy.

While I welcome the package of fiscal deficit reducing measures recently introduced, involving revenue mobilization and expenditure reduction, I wonder whether planned expenditure curbs and the substantial increase in user fees proposed in the health sector would not adversely affect access to health services in the country. Under the circumstances, the argument that a reduction in health expenditure could be effected without causing welfare losses is not very convincing. I would appreciate the staff's comment on whether there is room for further reduction in defense spending as a way of taking the pressure off the health sector.

In less than one year from now, all national trade barriers among the EC countries will be removed. While this would serve the best interest of the member countries, including Italy, most developing countries are concerned that unless the Uruguay Round of multilateral negotiations on trade and tariffs is successfully concluded this year, the emergence of regional trade blocs, like the EC, could lead to further reduction of market access in industrial countries for developing countries' primary export commodities and light manufactures. In this regard, I urge the Italian authorities to cooperate with, and encourage, other EC

members to ensure an early and successful conclusion of the Uruguay Round.

The net disbursement of Italy's official development assistance declined from 0.42 percent of GDP in 1989 to 0.32 percent of GDP in 1990. In fact, commitments showed a persistent and more significant decline from 0.67 percent of GDP to 0.34 percent between 1986 and 1990. As revealed in Table 43 of the background paper, the decline was reflected in both bilateral and multilateral contributions. We urge the Italian authorities to take the steps necessary to remove all legal impediments to raising the level of their development assistance, and we hope that there will be an early reversal of the current trend and renewed efforts toward attaining the UN target of 0.7 percent of GDP.

Mr. Al-Jasser made the following statement:

As economic integration in the EC gains momentum, the necessary convergence objectives continue to elude the Italian economy. Inflation and interest rates, as well as the fiscal deficit and debt ratios, are still out of line with the rest of the country's major EC partners. Moreover, external competitiveness continues to deteriorate, while capital inflows have declined substantially. Hence, the need for decisive and marked fiscal consolidation remains critical, particularly in light of the growing debt burden. It is, however, encouraging to note from Mr. Filosa's statement that the authorities are fully cognizant of this situation.

Although the Maastricht Treaty confronts the authorities with a major challenge, it also provides them with an appropriate opportunity to rally domestic support for an ambitious and far-reaching fiscal consolidation effort. Hence, I welcome the authorities' convergence program for the period 1992-94 that has been submitted to the Community's multilateral surveillance process, particularly since it incorporates explicit fiscal targets in nominal terms. However, I share the staff's view that this difficult task represents the minimum effort necessary to achieve convergence by 1996.

It is of concern that over 50 percent of the measures included in the 1992 budget were of a one-off nature. More significantly, the realization of the nominal fiscal targets requires additional measures that amount to 1 percent of GDP. Both facts do not auger well for the implementation of the program, and consequently, a more vigorous attempt at fiscal consolidation appears to be necessary.

Given that revenue increases were the main cause of the marked decline in the primary deficit over the past few years, a

far greater effort to reduce expenditures is needed. I share the staff's view that greater adjustments in all key areas of non-interest expenditures, including health and social security, are needed. Moreover, it is essential to contain the wage bill because of its direct impact on fiscal consolidation and its contribution to the disinflationary strategy. The authorities have indicated that civil service wages would rise only in line with the inflation target, while a cap on employment growth would be observed. In this context, I welcome the indexation of wages to targeted inflation, and I encourage the authorities to reduce further the indexation coverage as doing so would have positive effects on competitiveness. Furthermore, the staff's proposal for a freeze on public sector employment deserves consideration.

In light of the need to reduce public expenditures, I was surprised to find no mention of government subsidies in the staff report or in the accompanying papers. The elimination of subsidies, including agricultural subsidies, could contribute to fiscal consolidation and enhance economic efficiency. It is particularly important to specifically address these issues in the Article IV consultations of major industrial countries. I trust that future staff reports would cover such important issues.

With respect to tax reform, there is a need to enhance tax compliance and improve the efficiency of tax administration, and I agree with Mr. de Groote that some tax reform could contribute significantly to fiscal consolidation. In this context, it is crucial to restructure domestic taxation with a view to reducing the highly distortive and excessive taxation of petroleum products. It is beyond reason that in 1990, according to our estimates, the Italian Government earned $31.5 billion from taxing oil imports in 1990, while oil producers earned only $13.9 billion from their exports to Italy. This would be aggravated further if the EC were to implement the proposed energy tax, which, contrary to the claims of its proposals, is heavily biased against oil, given the lack of an initial level playing field. In this context, I would appreciate some clarification from the staff regarding taxes on non-oil energy products and the possible subsidization of coal production.

It is clear that the exchange rate regime did not provide sufficient flexibility to pursue an extremely tight monetary policy. However, I share the authorities' conviction that even if monetary policy could have been severely restrained, it is inappropriate to adopt a very tight monetary policy and only a gradual fiscal consolidation path. Such an unbalanced policy mix would have dramatically aggravated the deterioration in external competitiveness as well as the debt burden. Consequently, the authorities need to adopt a tight incomes policy and accelerate fiscal consolidation through tax reform and an aggressive privatization program.

I welcome the recent liberalization of trade restrictions regarding imports from Eastern Europe and the former U.S.S.R., and I call on the authorities to rapidly extend the same treatment to all developing countries. In this regard, I welcome the reaffirmation of Italy's commitment to increase its official development assistance.

Mr. Clark made the following statement:

We broadly share the concerns expressed by previous speakers, as well as the staff's appraisal. Therefore, I will limit myself to a number of brief remarks and questions.

First, the staff report strongly suggests that the 1992 budget--with its overreliance on one-off measures--represents an inadequate base for the authorities' medium-term fiscal objectives. Moreover, as the staff noted, it appears that slower than projected growth and other factors imply that the budgetary outcome for 1992 will be at least 1 percentage point of GDP higher than the official target of 8.4 percent. Indeed, we understand that private sector forecasts of the deficit range as high as 10.5 percent of GDP.

Besides the factors mentioned by the staff in the background paper, I wondered whether interest expenditures represent an additional significant risk to the 1992 fiscal outcome. In particular, I was struck by the fact that interest payments are projected to decline slightly as a share of GDP, despite the anticipation of an increase in the debt/GDP ratio. This seemed odd given the recent uptick in short-term interest rates, and the fact, as the staff noted, that much of Italy's public debt is short term. Could the staff comment on the likelihood that interest outlays have been understated, and could it indicate whether there has been a significant effect on interest costs owing to last year's downgrading of Italy's public debt by Moody's?

My second point relates to the emphasis that has been placed on the need for convergence between the rate of inflation in Italy and the lowest rates in the EC, a goal that we can certainly endorse. Nonetheless, I wonder whether the fascination with the relative rate of change in prices between the EC and Italy does not obscure the fundamental issue of relative price levels. Given that inflation in Italy has exceeded that in its major EC partners for at least the past decade, it seems apparent that the commitment to the ERM will require a relative disinflation to restore balance of payments equilibrium and the health of the tradable goods sector. If so, the abolition of private sector indexation represents a useful first step. However, it is a matter of concern that the authorities' plan to link public sector wages to

targeted inflation rates may unduly delay the reduction in real wages that appears necessary. The staff certainly recognizes the importance of this issue in its report. I wonder, however, whether the staff has estimates for the real effective depreciation that might be required to restore Italy's competitiveness?

Third, the authorities appear to be placing some importance on sponsoring negotiations between the unions and private sector employees. The staff report notes that incomes policy could "be an effective temporary tool to attain the inflation targets and restore competitiveness," but I would emphasize the point made earlier in the report that such policies would have little effect in the absence of disciplined macroeconomic policies.

Finally, as other speakers have noted, it is clear that the most significant issue facing the Italian authorities is how to reconcile their domestic fiscal policies with their commitment to the ERM and the prospect of fuller economic and monetary union. We can, perhaps, take some comfort from the authorities' recently announced convergence program for fiscal adjustment, as well as the commitment contained in the recent communiqué of the Group of Seven finance ministers. However, the staff report is not persuasive that these good intentions can be translated into concrete action. Indeed, the fact that the Italian authorities--in commenting on the commitments made at Maastricht--saw room for interpretation of the fiscal convergence criteria as not strictly numerical criteria casts significant doubt on Italy's ability to conform to the requirements of the EMU.

Mr. Evans made the following statement:

Fiscal policy remains the key policy issue in Italy, and this has been covered by previous speakers as well as by the staff report. Therefore, I need not dwell on this issue as I did last year, and I will simply comment on two other, not unrelated analytical issues.

I found it interesting to see the staff report cast so heavily in the context of the convergence requirements of the EMU, not least given the failure of both Fund surveillance and market discipline over a long period of years to bring about any noticeable correction of the fiscal policy imbalance in Italy. It is heartening to see that there is now some objective requirements, much in the mold of a Fund-supported program, that the Italian authorities are committed to meeting. In that sense, we should welcome the complementarity between these convergence requirements and Fund surveillance. Of course, with a sizable number of important countries in Western Europe committed to these convergence requirements, there is not going to be an insignificant

effect on the global economy throughout this period, which is the good part of a decade. Perhaps we should look at the implications for other major countries, if, for example, the performance of the non-European Group of Seven countries were to diverge markedly from what is occurring in Europe. The Fund, in its surveillance practices, could confer an "associate membership" of the EMU on those non-European countries and judge their performance over that period by the same convergence requirements.

On the second issue, I do not share all of the enthusiasm of my colleagues for central bank independence. Fund research and experience have shown that central bank independence is neither a necessary nor sufficient condition for the attainment of monetary stability, and indeed, this is acknowledged in the staff report for Italy. But it is particularly interesting to see the emphasis given central bank independence in this case, given, as the staff report stresses, that the role of monetary policy in Italy is now so heavily circumscribed. Therefore, it seems that the Bank of Italy is gaining the independence to pursue a dependent monetary policy, dictated, of course, by the requirements of the EMS. I have raised this issue mainly because of the emphasis that it is being given and of the expectations that might arise concerning a significant--at least to the Bank of Italy--change. However, this change may not be significant for Italy's economic performance, which will remain heavily dependent upon the inadequacies of its fiscal policy.

Mr. Marino made the following statement:

Once again Italy provides us with an extraordinary opportunity to consider an interesting case in which the fundamentals of economic theory and the instruments of economic analysis are challenged in the search for answers that could lead to a definite solution to the complex economic problems that the Italian economy is facing. As we share the views of Mr. Filosa and the staff, I will comment only on some specific topics.

The control of inflation continues to be one of the main challenges for the Italian authorities, not only because of inflation's negative effects on the domestic and external economy, but also because it represents an important obstacle on the road to economic integration. In order to advance on the inflationary front, the two key elements that need to be addressed are the structural weakness of the public finances and the reduction or elimination of indexation mechanisms. In addition, to improve the effectiveness of monetary management and efficiency in the allocation of financial resources, strong reform of the financial system and the capital market is required.

Significant changes in the legal and regulatory framework would contribute to achieving fiscal discipline. Several factors account for the difficulties encountered by the Italian authorities in their task of reducing fiscal imbalance. The temporary measures introduced can be useful only if the intention is to buy time while structural reforms are introduced. Although direct and indirect tax contributions to government revenue are about the EC average, much needs to be done to reduce tax evasion and to improve tax collection. A simplification of the tax system could provide significant progress in this direction. The adoption of ad hoc indirect taxes and the substitution of changes in income tax for social security contributions seem to be steps in the opposite direction. In addition, further efforts are needed to rationalize public expenditures.

One of the major problems that affect public finances is the level of public debt. The staff presents an interesting analysis of this topic. It reveals the danger of an acceleration of the increase in the debt/GDP ratio when the differential between the interest rate and GDP growth widens. Unfortunately, that seems to be the case for Italy in 1991. The heavy burden of the debt service imposes a severe constraint on the achievement of fiscal balance. The magnitude of the problem requires an aggressive program aimed at reducing the debt level. The first step in this direction is, of course, the achievement of primary surpluses, as envisaged in the budget for 1992. Another mechanism that could be explored is the combination of privatization with debt reduction operations. We would appreciate comments from the staff and Mr. Filosa regarding the viability of these operations. This might be a way to cope with the difficulties related to the lack of a well developed stock market as an obstacle to privatization.

On the use of privatization proceeds to reduce public debt, mentioned by Mr. Wright, we wonder whether there is some quantification of this possibility. Such data could help to improve the fiscal situation and increase the velocity of Italy's convergence.

Management of the debt structure and its financial framework may provide some positive effects. In this regard, the recent movement toward fixed rate bonds could be important. However, the response of the market should be monitored closely, particularly when important changes in interest rates are expected. One factor that needs to be considered is the impact of those changes on the market value of the fixed bonds, how it might affect their negotiability in the secondary market, and the conditions under which new debt is to be issued. We would appreciate additional information from the staff on this matter.

With respect to financial sector reform and the need to design mechanisms that could contribute to the deepening of the capital market, the simplification and reduction of reserve

requirements should be accomplished without delay. The distortionary effect of the implicit tax produces an inefficient allocation of financial resources and affects the structure of interest rates, more so when the reserve ratios vary depending on the instrument or the nature of the financial institution. We welcome the recent steps toward reduction; however, we have some concerns about allowing financial institutions to maintain part of the required reserves outside the central bank. In the absence of close and adequate supervision, this operational change could weaken monetary control, thus jeopardizing central bank efforts to reduce interest rate volatility.

Further efforts are needed to promote the development of the stock market. In this regard, the privatization process should be seen not as an element affected by the lack of development but, on the contrary, as an instrument that could help in that development.

Finally, we, as developing countries, understand perfectly the challenge that the authorities are facing on the road to structural reform. We also acknowledge Italy's active role in the financial support of developing countries.

Mr. Fridriksson made the following statement:

I agree with the staff's overall assessment of the Italian economy and with its policy recommendations, so I shall focus my remarks on just a few areas. Italy is strongly committed to the European economic and monetary integration process, as recently evidenced by the signing of the Maastricht Treaty, with its explicit conditions for entry into the third phase of the EMU. At the same time, it is clear that Italy's economy falls substantially short of meeting the necessary conditions. As the staff declares: "Italy's economic and financial position remains out of line with respect to the convergence requirements of EMU." The magnitude of the convergence requirements, together with the timetable laid down in the Maastricht Treaty, poses a sizable challenge for the authorities while time is rapidly running out.

A reduced fiscal deficit is the key to convergence. Failure to effectively redress the ailing public finances during the recent period of high growth has left the Italian authorities in the position of having to implement substantial fiscal adjustment during a period of general economic slowdown. With a public sector deficit still about 10 percent of GDP and a public debt level above 100 percent of GDP, corrective action must be expedited.

I do not intend to comment on each item in the array of areas within the public sector that the staff has identified as needing

major reforms. I will just make the observation that, although reform of the tax collection system to reduce evasion is clearly needed, the fundamental aim of the reform of the pension system, the health system, and the general civil service must be to reduce overall public spending. The general level of taxation in Italy is already close to the EC average and tax increases must not be relied on to reduce the deficit.

The fact that there has been virtually no convergence in inflation toward the best performers in the EC is worrisome. The resulting deterioration in competitiveness, squeeze on profit margins, and loss of market shares endanger the exchange rate policy and thereby the ability of Italy to fully participate in the European monetary integration process. I might add that included in that effort must be the elimination of the indexation of wages and salaries.

It is fair to say that Italy stands at a crucial point in time. Important decisions laying out the path for further ingration of the EC through the decade have recently been taken. If Italy is to be able to fully participate in this process, which I know is its desire, decisive steps to redress fiscal imbalances and to reform central parts of the Italian economy can no longer be postponed. The measures presented so far fall short of what is needed.

Mr. Wei made the following statement:

As shown in the staff report, economic policies in Italy are increasingly conditioned by the requirements of European economic integration. However, at the same time, it is clear that economic policymaking in Italy is seriously constrained by the level of the public sector deficit and by inflation, which has remained stubbornly high in terms of the convergence criteria. The need to scale down both, especially the fiscal deficit, is urgent not only to achieve EC convergence but also to free the authorities from present policy dilemmas and to enable the economy to operate under healthier conditions.

I am in general agreement with the staff appraisal and share many of the points made by previous speakers. On the fiscal deficit, we have noted from the staff report and Mr. Filosa's statement that, as a result of various corrective measures taken in the fiscal area in the past year, the primary deficit and central government borrowing requirement continued to come down in relation to GDP, although the decline still fell short of target. However, much of the decline in the deficit was brought about by efforts focusing on the revenue side, although revenue performance also fell short of expectations. In view of current fiscal condi-

tions, it is essential that further steps be taken to cut expenditures.

Meanwhile, a strong push on the structural side of the fiscal problem cannot be delayed any longer. Tax administration and the health service and pension systems are among the key areas that call for decisive, concrete, and immediate action. In this regard, we welcome the steps taken by the authorities to improve tax administration in general and to fight tax evasion, and we hope that proposals to reform the health service and pension systems can eventually work their way toward reducing the present structural weaknesses in public finances.

As indicated by the staff report, the authorities have taken steps to further liberalize trade. In July 1991, for example, most restrictions regarding imports from Eastern Europe and the former U.S.S.R. were lifted. This represents a welcome effort that should be continued and expanded to further reduce and eliminate trade barriers to countries outside the EC. It should indeed be an integral part of the endeavor to promote a global multilateral trading system.

Finally, the authorities have made commendable efforts in the past decade with regard to disbursements for official development assistance. As the recent decline in the level of assistance has been due to exceptional legal and administrative reasons, as explained in the staff report, we hope that the situation will soon be ameliorated.

Mr. Mojarrad made the following statement:

The performance of the Italian economy in 1991 was paradoxical. While GDP growth slowed down sharply, it did not reach the same low levels experienced by several other industrial countries. Despite the slowdown in output growth, the unemployment rate declined markedly over the past year. While consumer demand remained strong, business investment fell short of expectations, showing a negative growth rate of 0.6 percent. Investment in the construction sector stagnated after several years of growth, followed by a much gloomier performance in the machine tools and equipment sector, which showed negative growth of 1.8 percent.

In 1991, the general price increase remained at 6.4 percent, almost as high as that in the previous year. This level of increase was far beyond the convergence criteria of the lowest-inflation EC countries. This inflation differential vis-à-vis the lowest-inflation EC countries is a cause for concern, because the exchange rate pegged to the deutsche mark had not been sufficiently instrumental in reducing the inflation in recent years.

Therefore, there is a need to emphasize broad-based anti-inflation measures to reduce inflation significantly. Since monetary policy is committed to exchange rate stability and has limited room for maneuver to attain inflation convergence, fiscal and incomes policies could be considered alternative policy action for the authorities.

Fiscal policy is critical, because of the higher than expected budget deficit. Public debt increased to 104 percent of GDP in 1991, far beyond the criterion established under the EMU. In the third stage of the EMU, member countries should avoid an excessive deficit, defined as 60 percent of GDP. Tax reforms are highly recommended, since indirect taxes, contributing 11 percent to total current government revenue, ranked lowest among EC member countries. Efforts to prevent tax evasion should be reinforced. Creation of a veritable tax force and application of more severe penalties, as recently undertaken, are steps in the right direction. The structural measures adopted to improve tax administration are highly welcome. Increased by close to 11 percent, salaries are well ahead of consumer prices. However, we are pleased to note the linking of public sector wage increases to inflation targets and the incomes policies agreed with the social partners for 1992. The authorities are encouraged to take note of the need for wage moderation in order to preserve Italy's competitiveness. Moreover, the authorities are urged to implement fundamental structural reforms in the areas of health services, pensions, and public employment.

The Italian banking system might encounter problems in the unified Europe, since it has to compete with more efficient and independent banking systems, such as those of Luxembourg and others. However, recent development in creating a powerful central bank, independent from the Government, will, it is hoped, lead to a more efficient system, immune from political pressures.

In the external sector, the current account has remained in deficit for the fifth consecutive year. While the decline in exports is largely attributable to global economic conditions, the deterioration of invisible exports, such as transportation and tourism, gives cause for concern.

We hope that the Italian authorities will play a constructive role in promoting an early agreement of the Uruguay Round. We commend the authorities for their official development assistance and hope that the recent decrease will be reversed in the future.

The Director of the European I Department, commenting on the debt structure, said that the amount of long-term, fixed-rate securities outstanding was still a relatively small portion of total public debt. The average maturity of government debt in Italy had recently increased from two

years and five months to two years and eight months. The Government was aware that, with present inflation expectations, the cost of fixed-rate bonds was relatively high. At the same time, the Government realized that the need to reduce the position of variable-rate debt, and the large borrowing requirement in relation to GDP, called for a more diversified debt structure.

The holder bore all of the interest rate risk on fixed-rate bonds, the Director continued. The Government paid fixed coupons on these bonds. As the secondary market was now working well, the owners of securities were generally able to liquidate them without affecting the price.

The amount of resources that could be mobilized by privatization was significant, the Director stated. The Italian Government owned a large sector of industry, through various holding companies, and sizable real estate holdings. The amount programmed to be collected was Lit 15 trillion in the 1992 budget. Of course, there were limits to how much could be sold in a short time on the domestic security market; therefore, the Italian Government might also have to go abroad to sell securities. The issue was not so much the availability of enterprises to privatize, but rather agreement within the coalition parties to do so. In the staff's view, those resources should be used to reduce debt, and therefore reduce the imbalances referred to by Mr. Végh.

There were no major differences between the staff and private forecasters on the projected overshooting of the fiscal deficit, the Director noted. The staff's estimated overshooting of 1.5 percentage points of GDP was consistent with the private sector forecast of a deficit of 10.5 percent, compared with the 9 percent official target; the staff's estimated overshooting of 1.1 percentage points of GDP applied to the primary deficit.

It was not possible to isolate the effect of Moody's downgrading of Italy's public debt, the Director remarked. Italy had reduced the issues of foreign debt immediately after Moody's action, but the authorities' subsequent actions and the effect on interest rates were difficult to ascertain.

As to the real effective depreciation needed to restore competitiveness, many factors were involved, the Director continued. If the staff started with the year after the last realignment, namely, 1988, as a base, then the required depreciation would be about 7 percent in real terms.

The figures for subsidies to industry, particularly to energy, were not available, but in Italy, as in other EC countries, subsidies had been declining, the Director said. Subsidies were subject to a legal regime in the EC, and the EC and the Italian authorities were discussing their reduction. However, the Italian authorities did not consider the recapitalization of state holding companies a subsidy but the responsibility of the Government as a shareholder. The staff would provide more information on the matter in other consultations; for the present discussion on Italy, the staff had concentrated on the requirements of convergence.

The staff would also look more closely at taxation on coal, but unlike in other European countries, there was basically no domestic production of coal in Italy, the Director remarked. Agricultural subsidies were those called for under the EC Common Agricultural Policy and had to be considered in that light, although the staff was aware of the distortion of agricultural policies in Italy as elsewhere.

Defense spending in Italy had never been very high and had not reached the level required under the NATO commitment, the Director of the European I Department observed. Defense was the area of budget expenditure that the authorities would consider first for cuts. Unemployment benefits in Italy were not particularly high compared with those of other countries. The Wage Supplementation Fund appeared high, but it was financed by industry and workers in the form of insurance, and the Government stepped in only when a deficit appeared. The unemployment benefit amounted to 20 percent of the last wage, which was not high by European standards.

Mr. Filosa commented that Directors' specific observations, suggestions, and criticisms constituted the surveillance process. He wished to reassure Mr. Posthumus that, for the third consecutive year, not only were the recommendations of the staff mission carefully considered by the Minister, they were also published following the conclusion of the mission. In addition, during the Managing Director's frequent visits to Italy, he had had many occasions on which to exchange views with the authorities. Because important issues were at stake, communications between the Fund and the authorities were frequent and current.

He did not take issue with the observations of the staff on the fiscal position, in particular that additional measures might have to be taken in the 1992 fiscal package, Mr. Filosa remarked. His authorities were aware of the criticisms and shared many of them. The convergence program submitted to the EC should be considered from the perspective of the need for concurrence on monetary, exchange rate, and incomes policies as well as fiscal consolidation. No one policy could be seen in isolation, and only the successful, concurrent implementation of all of them could help to achieve nominal convergence.

Incomes policy, particularly in the public sector, was absolutely crucial to achieve the fiscal objectives, Mr. Filosa noted. However, incomes policy in the public and private sectors, without monetary and exchange rate policy, could not achieve the inflation and other convergence criteria. Also, the criteria for interest rates could not be achieved unless inflation objectives, through all those means, were reached. Thus, in looking at the different aspects of convergence policy, it was necessary to consider that exchange rate and monetary policies alone were incomplete and that convergence would require full implementation of all aspects.

Another point that had been raised concerned the authorities' room for interpretation of convergence criteria, Mr. Filosa added. Italy's Fiscal Plan included the same numerical targets as the EC convergence program, with the ultimate goal being elimination of the current expenditure deficit and a

total deficit of 3 percent--equal to capital expenditure--of GDP in 1996. The question then was, if those targets were reached and the debt/GDP ratio fell rapidly to the 60 percent target, whether that constituted compliance with the convergence criteria or with the requirement of Fund surveillance. He believed that even if the debt/GDP ratio stayed above 60 percent for a while, but all other paths followed the program, then convergence would be significant and should be recognized as such by the EC as well as by the Fund through its surveillance exercise.

In the short term, the Italian economy was committed to actively implementing a broad range of institutional changes, as reflected in the passage the previous day of the central banking law, Mr. Filosa commented. As to the independence of the Bank of Italy, he could also refer to the observation of Chairman Volcker about its autonomy vis-à-vis the Treasury, but the EC process was a move toward shared responsibility in monetary matters, not surrender. If, in the process, the behavior of a particular central bank limited the behavior of others, that was because Germany continued to be the anchor for the System. The goal was a greater share of responsibility in the field, and monetary independence would have potentially beneficial effects vis-à-vis non-European central banks.

While Mr. Végh's unpleasant conclusions regarding the fiscal position were true, it was important not to lose sight of the cyclical situation, Mr. Filosa remarked. The matter had to be assessed from a medium-term perspective for one specific reason: the rate of growth of GDP in 1991 had been 1 percent. Cyclically, to achieve stability of the debt/GDP ratio, Italy should have lowered the interest rate substantially or compensated the primary balance for that slow growth. But there was a limit to Italy's ability to change the interest rate--a limit that had been reached toward the end of the year--and the exchange rate constraint implied that some interest rates could not be changed further. Also, to accommodate the deceleration of the economy, it would be necessary to change the primary surplus by 4-5 percent in one year, which was impossible. Therefore, while not losing sight of the objective, it was cast in a longer-term perspective.

The question had been raised as to whether monetary policy could be more aggressive, Mr. Filosa recalled. Minor deviations from what was deemed the implicit interest rate suggested by the exchange rate had apparently indicated that there was little room for maneuver. Here again, he would underline the need for complementarity of policy. Monetary policy alone was not useful and could run counter to the stability of the exchange rate in the EMS.

On structural policy, a great deal of restructuring of industry had taken place so as to increase productivity, Mr. Filosa said. It was not by accident that the largest share of Italy's exports was to Germany. While he could not state what should be done to increase productivity, he could point out that as part of the fiscal reform, the stock of plants would be revalued and the firms would pay taxes on the revalued stock, as part of the increase in taxation envisaged in the program. In the following years, however, that revaluation could be the instrument for a depreciation allowance, creating

some deceleration of tax revenue from that source, while encouraging modernization of the stock of plants.

As to the chance of a crisis being provoked by the convergence criteria of the EMU, the rationale was quite the opposite, Mr. Filosa observed. The exchange rate could be considered an instrument for commercial policy, for tax policy, and, less important, for adjustment to real economic shocks. As an instrument of commercial policy, the exchange rate affected the relative price of traded goods; its use for that purpose ran counter to the aim of compression of the internal market. As an instrument of tax policy, the exchange rate reflected the different inflation taxes involved in holding different currencies. In a fully integrated area, such as the EC, the exchange rate should not be used for commercial purposes, and its fiscal usefulness was short lived; that rationale formed the basis for the EMS exchange rate policy.

The more important area of nominal convergence--inflation--meant that the EC and Italy had repealed a country's freedom to choose among different inflation targets, Mr. Filosa said. The exchange rate policy of the EC and of Italy did not provide an escape from monetary and fiscal discipline, including incomes policy. In sum, the exchange rate policy envisaged in Europe and in Italy was one that did not consider depreciation a substitute for sound domestic policy, and that was what the convergence plan signified.

Some uncertainty had been expressed about the timing of government implementation of the convergence plan, but the authorities' commitment conformed to EC procedures, Mr. Filosa concluded. A shadow program did not seem necessary, and any reinforcement of what might be considered weak multilateral surveillance procedures in the EC would, he hoped, be supported by Mr. de Groote.

The Chairman then made the following summing up:

> Executive Directors endorsed the thrust of the appraisal in the staff report for the 1991 Article IV consultation with Italy. They noted the deterioration in the performance of the Italian economy in 1991 relative to the more favorable trend of recent years. Output growth had slowed markedly, investment had contracted, and exports had stagnated, reflecting a loss of competitiveness. Despite the deceleration of aggregate demand, the external current account had remained in deficit for the fifth consecutive year and inflation was stubbornly high, impeding progress on convergence to the lowest-inflation EC countries. On the fiscal front, outturns had once again fallen short of target; the narrowing of the primary deficit in 1991 was to a large degree attributable to measures with only a temporary effect; progress in reducing the underlying imbalance had remained unsatisfactory.
>
> Directors observed that the staff had placed its analysis in the perspective of EMU convergence criteria. They welcomed the commitment of the Italian Government fully to participate in the

process of European economic and monetary integration as specified in the Maastricht Treaty. They warned that the degree of divergence at present and the timetable set in Maastricht called for determined and sustained action over a number of years that would require the development of a fundamental political and social consensus. Directors noted that the targets included in Italy's medium-term convergence program were a minimum requirement that would need to be pursued whatever the underlying macroeconomic developments.

Directors were concerned that the measures envisaged in the 1992 budget--the first under the convergence program--appeared insufficient to achieve the budgeted targets and relied once more too heavily on temporary remedies and on intervention affecting the borrowing requirement rather than the underlying public deficit.

Directors welcomed the adoption of structural measures aimed at improving tax administration and broadening the tax base but urged the Italian authorities rapidly to implement fundamental structural reforms in the areas of health services, pensions, and public employment. They welcomed the progress being made toward privatization but reaffirmed that the sale of public assets was no substitute for fiscal adjustment in the long run.

Directors expressed concern about the stubbornness of Italian inflation and the consequent failure to reduce the inflation differential vis-à-vis the lowest-inflation EC countries. The maintenance of the peg vis-à-vis those countries' currencies had been instrumental in reducing inflation but had not been sufficient in recent years to induce further nominal convergence, and monetary policy was limited in its scope by the commitment to exchange rate stability. Directors, therefore, underlined the conflict that would eventually arise between that commitment and inflation convergence if early progress in reducing inflation significantly was not made. They therefore emphasized the need for a broad-based anti-inflation policy.

In particular, they stressed the importance of wage moderation, and, in this regard, most Directors welcomed the linking of public sector wage increases to the inflation targets and the agreement on incomes policies for 1992, recently reached between the Government and the social partners. While some Directors called for efforts to consolidate the gains in incomes policy, others reiterated their skepticism in that area. All speakers emphasized that besides tight financial policies, structural measures spurring competition and productivity growth should help reduce cost pressures and at the same time lower unemployment in the medium term. Most Directors were pleased to note that the Bank of Italy had been granted full autonomy in the setting of the discount rate, and they expressed the hope that

additional steps would follow to strengthen its independence further.

Finally, Italy was urged to play an active role in seeking to promote an early agreement in the Uruguay Round and to reverse the recent decrease in Italy's official development assistance.

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

3. MOROCCO - REQUEST FOR STAND-BY ARRANGEMENT

The Executive Directors considered a staff paper on Morocco's request for a 14-month stand-by arrangement in an amount equivalent to SDR 91.98 million (EBS/92/6, 1/14/92).

The staff representative from the African Department made the following statement:

Since the issuance of the staff report (EBS/92/6), the Moroccan authorities have confirmed that the prior actions under the program have been taken, namely, that: (1) the 1992 budget, including the envisaged revenue measures, was approved by the Parliament; (2) the necessary procedures to ensure that government expenditure be limited to the amount programmed were put in place; (3) the further liberalization of the interest rate system was implemented; (4) the decision to conduct open market operations by Bank Al-Maghrib was taken; (5) the agreement between the Ministry of Finance and Bank Al-Maghrib on government financing from the central bank was concluded; and (6) the draft banking law was considered by the Council of Government.

The authorities have also provided preliminary data indicating that the budgetary outcome in 1991 was broadly in line with the estimates in the staff report, with net outstanding bank credit to the Government at end-December 1991 being somewhat lower than projected. Preliminary data also indicate that the balance of payments outcome was better than projected, partly owing to developments in the current account, with the result that total net foreign assets at end-1991 were about DH 1.8 billion (about SDR 150 million) higher than estimated, equivalent to some 0.3 months of imports of goods and services. In view of the impact of this development on the liquidity of the banking system, the monetary authorities increased the reserve requirement on sight deposits by 2.5 percentage points to 22.5 percent on January 23, 1992.

Mr. Kabbaj made the following statement:

My Moroccan authorities welcome this opportunity to discuss their economic and financial program for 1992, which is designed in a medium-term framework and which aims at restoring Morocco's external viability with the establishment of the convertibility of the dirham for current account transactions in 1993.

Our last discussion on Morocco took place in March 1991, at a time when large uncertainties clouded the world economy and the economy of many countries of the region, including Morocco, as a consequence of the Middle East crisis. The Executive Board, while commending the Moroccan authorities on the overall economic performance in 1990, especially in light of the previous year's exceptional circumstances, recommended to the authorities a marked strengthening of their fiscal effort and of monetary policy. The Board also advised the authorities to deepen their structural reforms with a view to fostering liberalization of trade and prices and strongly encouraging private sector activity. Executive Directors stressed the importance of eliminating exceptional financing at the public sector level in order to achieve balance of payments viability.

The authorities were in broad agreement with these recommendations and, since that time, have been in close contact with management and the staff to formulate a coherent program that generally reflects these objectives. This process of policy formulation and implementation of policies was unfortunately hindered by the uncertainties stemming from the Middle East crisis. In particular, the authorities were uncertain about the prospects for reversing the deep decline in tourism receipts that occurred during most of 1991. This situation, with all its consequences on activity in major sectors of the economy such as hotels, airlines, and handicrafts, and on employment, coupled with the loss of certain promising export markets, did not allow the authorities and the Fund staff to agree thoroughly on the feasibility of a program. In particular the authorities expressed their concern that the program might not succeed in allowing Morocco to ensure its graduation from exceptional financing.

In the event, and beginning in late September 1991, the situation stabilized, and it became possible, during the final stages of the budget preparation, to negotiate the program that is before the Executive Board today.

Before addressing the issues related to the program itself, I thought it would be useful if it could be put in perspective. The adjustment efforts undertaken by Morocco under successive programs supported by the Fund and the international financial community are now bearing fruit, and the authorities rightly believe that their experience constitutes a good example of adjustment

associated with real growth and without major disruptions to the economy. Some could argue that a less gradual approach would have produced similar results in a shorter time span. This is a difference of opinion that cannot be resolved within the framework of this discussion. But it is clear to the authorities that their adjustment has been based on deep structural reforms that took time to formulate and implement; however, this time was not lost and was used to ensure the success of these reforms and avoid the disruptions observed in other cases.

The problems that faced the authorities during the past decade dated back to the end of the 1970s, when Morocco was hard hit by two oil shocks and by the plunge in phosphate prices. Domestic and external deficits amounted to close to 20 percent of GDP. As I have stated many times in the Board, the authorities have been making relentless efforts to cope with this difficult situation. If their efforts up to the mid-1980s did not appear successful, it was not for lack of adjustment--far from it: it was mainly because their efforts were hampered for five years by recurrent droughts, sharp increases in international interest and exchange rates, a prolonged crisis in the phosphate sector, and other exogenous factors. It was also because they were laying the groundwork for structural reforms, notably in trade liberalization, fiscal reform, and public enterprise reform, the results of which did not materialize before the second half of the 1980s, as is evident from the staff report.

The results of these policies are today clearly apparent. Growth has picked up, and inflation declined. Although the rate of inflation recently increased--a development that will hopefully soon be reversed--Morocco's inflation rate is one of the lowest among developing countries. Investment is rather high, at 24-25 percent of GDP. Savings increased sizably. Budgetary and external deficits are at more manageable levels. The external debt ratios, although still high, have declined, and the debt-service ratio will be below 30 percent of exports next year. External reserves are equivalent to almost four months of imports, while they were almost nil in 1983. This is not to say that the Moroccan economy is free of problems. The authorities are keenly aware of the necessity of addressing more forcefully the social aspects of development, which could not be satisfactorily dealt with during the period of financial pressures. This will, however, be done without jeopardizing the hard-won domestic and external equilibria.

I would like to now turn to the program for 1992, for which Fund support in the form of a stand-by arrangement is requested. This program builds upon the satisfactory results of 1991. It is heartening to note that preliminary data, as reported in the staff's statement, indicate that developments were broadly in line with the estimates of the staff report. The program objectives

are the achievement of real growth of 4 percent, a reduction in the rate of inflation, as measured by the GDP deflator, to 5 percent, and a reduction of the external current deficit to 2.1 percent of GDP. The policies and measures necessary to attain these objectives are now in place, and the authorities are motivated and committed to reach their goals, in particular regarding the graduation from exceptional financing and the establishment of the convertibility of the dirham for current account transactions in 1993, the latter as a first step to full convertibility to be attained through further steps to be carefully formulated with Fund technical assistance.

The centerpiece of the program is the budget, which was adopted by the House of Representatives at the end of December 1991. The authorities firmly intend to promote the private sector as a vehicle for development and employment creation, and they are fully cognizant of the need to release resources to this sector. To this end, the budget contemplates a sharp reduction of the deficit of the Treasury from 3.1 percent of GDP in 1991 to 0.8 percent of GDP in 1992, and it is envisaged that a small surplus will be achieved in 1993. All the revenue measures are of a structural nature and are included in the approved budget, the final outcome of which is somewhat better than the one described in the staff report. On the expenditure side, stringent containment measures have been taken, including a quasi-freeze on salaries, limited recruitment, mainly for the education sector, and a reduction in real terms of capital expenditure, with a reorienta-tion of this type of expenditure toward infrastructure that is linked to private investment and social needs.

Monetary policy was considerably tightened to achieve the reduction in inflation and to release sufficient credit to the private sector. Here, too, all the measures are in place, including a recent increase in reserve requirements reported in the staff statement and which was not part of the program. This shows that the Moroccan authorities are now using the indirect instruments at their disposal and that the far-reaching reform of credit desencadrement is now working. Additional steps were also taken to further liberalize lending rates, while variable interest rates were introduced for the first time.

On the external front, Morocco is pursuing its policy of liberalization of trade and foreign exchange controls and is preparing for the convertibility of the dirham in current account transactions. As to external debt, Morocco intends to fully service all of its obligations beginning next year. It should be recalled that the total stock of commercial debt was restructured in 1990, and this debt is now fully serviced. Morocco allowed the deadline on debt reduction to lapse and thus is no longer seeking such a reduction. However, the possibility of reduction through debt buy-backs remains open.

Regarding Paris Club debt, Morocco is requesting a final rescheduling, mainly for 1991 maturities. This request should be viewed in the context of the graduation of Morocco from exceptional financing and of the necessity to provide a cushion against external shocks. As is evident from the staff's sensitivity analysis of the medium-term prospects, Morocco remains vulnerable to such shocks but could weather them if a sufficient cushion of reserves is available. The last World Bank structural adjustment loan to Morocco will be negotiated shortly, and after this loan the Bank will provide only project and sectoral financing. In fact, another structural loan that was envisaged was canceled by common agreement. It goes without saying that the authorities consider the requested Fund stand-by arrangement, if approved by the Board, to be the last arrangement. It is to be noted that this represents a shortening by one year of the period of Fund financing as contemplated in June 1990, when an arrangement under the EFF covering 1991, 1992, and 1993 was under discussion.

My authorities wish to thank the Executive Board for its continued support of Morocco during the difficult times it has experienced. They also are appreciative of the perfect cooperation they have always received from management and the staff, and they stress once again their commitment to sound macroeconomic policies and to a full liberalization of their economy.

Extending his comments, Mr. Kabbaj said that there appeared to be considerable interest in the question of Morocco's arrears. His authorities did not consider the financing gap as arrears and wished to reassure the Board that it was their firm intention to regularize the situation as envisaged in the program before March 31, 1992. That would be done through their adjustment efforts, mirrored by the sizeable agreed reduction of the budget deficit and by recourse to rescheduling. They had emphasized that it was not their intention to accumulate arrears. They had used the standard procedure of timely informing the Paris Club Secretariat of their intention to negotiate an arrangement with the Fund and of the partial suspension of payments. The suspension was related to current obligations and to obligations stemming from two rescheduling agreements, which was the basis used for the rescheduling of obligations related to the first three months of 1991 in the last Paris Club agreement. For 1990, the rescheduling covered three agreements already rescheduled.

It went without saying that Morocco continued to serve all of the post-cutoff debt, Mr. Kabbaj went on. Unfortunately, exceptional circumstances had made it difficult to reach an agreement with the Fund before November 1991.

In addition to the explanation he had already presented to describe the position of the authorities, he wished to add two points, Mr. Kabbaj continued. First, the budgetary situation would not have allowed much

larger payments beyond those made. Second, without prejudging in any way the position of the Paris Club, rough calculations showed that if the total size of the financing gap was covered through rescheduling, Morocco had been and would effectively be discharging increasing percentages of its obligations falling due, and the rescheduling process would be phased out in an orderly and reasonable way. Those percentages were 50 percent for 1990; 68 percent for 1991; 87 percent for 1992; and 100 percent for 1993.

Mr. Finaish made the following statement:

I welcome this clarification by Mr. Kabbaj.

Morocco has made significant progress in recent years in implementing structural reforms and pursuing macroeconomic adjustment policies. Economic growth accelerated, inflation was brought under a reasonable measure of control, and domestic and external imbalances were reduced. However, these accomplishments received a setback in 1991 following the Middle East crisis and events in Eastern Europe. Morocco's current adjustment program represents a determined effort to recapture the momentum of policy reforms.

The program before us is designed to restore domestic financial stability and achieve balance of payments viability in 1993, thereby setting the conditions for establishing currency convertibility. On the domestic front, a major effort is being undertaken to consolidate the fiscal position with the objective of attaining balance in 1993. The size of the fiscal adjustment in 1992, as discussed in the concise staff report, is impressive and embodies a number of structural measures, which I believe will go a long way toward enhancing the buoyancy of the tax system. On the expenditure side, the most noteworthy feature is the freeze in government base wages and salaries following the large upward adjustments in recent years, and the containment of recruitment. The task of generating productive employment opportunities in the economy should, as the authorities recognize, fall mainly on a dynamic private sector, an objective that should be facilitated by the proposed rationalization of the trade and incentive system and other measures aimed at bolstering domestic and external confidence in the economy. The tight stance of fiscal policy is to be buttressed by a restrictive monetary policy consistent with the need to mop up excessive liquidity, reduce inflationary pressures, and support the targeted improvement in the balance of payments.

On the external front, a viable balance of payments position, with no need for exceptional financing after 1993, appears to be achievable. Of course, the authorities recognize that this hinges on the pursuit of a restrained demand-management policy, in particular in the fiscal area, and the timely implementation of major structural reforms aimed at enhancing the competitiveness

and efficiency of the economy in the areas of public enterprises, the financial sector, transportation, and external trade liberalization.

Over the medium term, I believe there are good prospects of a continued strengthening in the external position based on the rapid growth of manufactured exports, a category that is likely to benefit most from the technology transfer associated with foreign direct investment. The resilience of the balance of payments is demonstrated by the staff's alternative scenarios, which simulate the combined effects of higher oil prices and lower phosphate prices. This shows that, even with such an outcome, Morocco would be able to absorb the terms of trade deterioration without resorting anew to exceptional financing.

Overall, I believe that Morocco's program for 1992 represents a strong and credible reaffirmation of the authorities' commitment to financial stability and structural reform and the staff supplement, which shows that all prior actions under the program have been taken, attests to that commitment. A strong adjustment effort can be expected to positively influence the provision of adequate external financial assistance by the donor community. As the staff rightly points out, such a response will be critical to the successful implementation of the program. Given the strength and comprehensiveness of the adjustment effort, I believe that Morocco is fully deserving of Fund support, and I can support the proposed decision.

Before concluding, I would like to comment on the social aspects of the program. It appears that a number of studies are to be launched to explore the effects of various policies and shocks on the poor, and that these studies will serve as an input into the World Bank's poverty alleviation component under the SAL II. While I can certainly welcome studies of this nature, it seems that the study recommendations will be available for implementation about the time the present stand-by arrangement will have been completed. This would be rather unfortunate. In my view, a safety net should have been designed as an integral part of the present stand-by arrangement.

Mrs. Martel made the following statement:

I, too, welcome Mr. Kabbaj's statement today.

We are pleased that Morocco is pursuing close cooperation with the Fund by embarking on a new stand-by arrangement. Indeed, this collaboration has been fruitful in the past, since Morocco has embarked on a comprehensive range of measures aimed at transforming its economy rapidly. It is particularly noteworthy that Morocco has reached very important progress in the second

part of the 1980s. The country has experienced a spurring of growth--the average annual growth rate of real GDP increased from 3.5 percent in the first half of the 1980s to 4.3 percent in the second half--a considerable reduction in the rate of inflation from 8.4 percent in 1985 to 5.7 percent in 1990, and a significant narrowing of the fiscal and external current account deficits, the former declining from 9.6 percent of GDP to 3.5 percent, the latter decreasing from 7.7 percent of GDP to 2.5 percent.

Last year's economic performance was less favorable: real GDP increased by 4.2 percent in 1991, the rate of inflation accelerated to 8 percent, and the external current account deficit, excluding grants, widened from 2.5 percent of GDP in 1990 to 3.1 percent in 1991. This situation was the result of a combination of exogenous factors, mainly the impact of the Middle East war on tourism and the weakened demand for Morocco's exports in Eastern European countries, and of endogenous factors such as the slowdown in the momentum of macroeconomic adjustment, specifically in the fiscal area.

Today's economic and financial program aims at restoring Morocco's external viability, establishing the convertibility of the dirham in 1993, and permitting a return to normal relations with the country's creditors. This is indeed a major, although by all means realistic, endeavor.

Morocco is on the right path of adjustment, and this program, which is part of a medium-term framework, certainly goes in the right direction. With these considerations in mind, I will comment on the program's main areas.

The budgetary policy is, as stated by Mr. Kabbaj in his helpful statement, a crucial element of the adjustment process. A rigorous policy in this sector is necessary so as to achieve a sustainable rate of growth and to promote the private sector in a stable financial environment. To this end, the Moroccan authorities intend to reduce the Treasury's overall deficit to 0.8 percent of GDP in 1992.

A main component of the effort bears on the total revenue, which is projected to rise by 13.9 percent. I agree with the staff's appraisal that the tax measures will certainly have an important impact on achieving a durable improvement in the budgetary position. In this regard, I welcome the elimination of the ceiling on the minimum corporate income tax on turnover, as well as the broadening of the value-added tax (VAT) base to include large retailers, the abolition of the 12 percent VAT rate, the transfer of the activities covered by it to the 14 percent and 19 percent rates, and the imposition of a specific tax on phosphate rock and derivatives. But I would appreciate it if the

staff could give us some information about the share of each of these measures in the projected increase in revenue.

On the expenditure side, first I welcome the measures for 1992 concerning the wage bill, which include a freeze on base government salaries and benefits and the containment of recruitment to less than 2 percent of size of the civil service. I note that the wage bill is projected to increase between 1991 and 1993 at a higher pace than total expenditure, and I would welcome some comments by the staff.

Second, also worth noting is the commitment of the authorities to closely monitor the operations of the local governments, particularly with a view to ascertaining that the job positions will be held in 1992 at the end-1991 level. In this connection, I would appreciate it if the staff could give us some precise information on the share in the adjustment effort; I particularly have in mind the transfer in expenditures from the Central Government to the local governments.

Monetary policy is also rightly rigorously designed. In order to avoid the recurrence of the monetary slippages of 1991, the authorities have chosen to tighten the monetary policy in order to achieve the reduction in inflation and to release sufficient credit to the private sector. In this regard, particularly noteworthy is the target of the growth of broad money at 6 percent in 1992. This is an ambitious goal, but one which is certainly consistent with setting up the proper conditions for enhancing competitiveness and establishing currency convertibility. This policy should be facilitated by the envisaged reduction in net credit to the Government and by the introduction of greater flexibility in interest rates combined with open market operations. Also encouraging in this connection is the recent increase in reserve requirements reported in the staff's opening statement.

Turning now to structural policies, I would like to commend the Moroccan authorities for the very important reforms that they have undertaken. Let me stress first the importance of the financial sector reform, which is supported by a financial sector development loan that aims, on the one hand, at developing the financial markets so as to enhance the mobilization of domestic financial savings and the attraction of foreign capital, and on the other hand, at modernizing the legal and regulatory framework of the banking system.

I would also stress the necessity to pursue these structural policies, especially in the public enterprises, as the restructuring of public enterprises as well as the scheduled privatizations should help release the necessary resources to the private sector.

Finally, this program should constitute the restoration of Morocco's external viability, which is already on the right path, notwithstanding the fact that, in the recent past, Morocco has accumulated arrears on the agreements made with its public creditors at a time when it had the capacity to respect its obligations, as evidenced by the increase in the external reserves. Despite a sizeable financing gap, we know that the overall financing situation is favorable and should enable Morocco to move toward normalization with its creditors. This should make it possible, as stated in the staff report, for the next--and hopefully the last--rescheduling agreement with the Paris Club to have a more limited coverage than the previous one.

In conclusion, my country strongly supports the Moroccan authorities in their endeavors and is particularly confident in the soundness of this program.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/92/10 (1/29/92) and EBM/92/11 (1/31/92).

4. OPERATIONAL BUDGET - METHOD OF ALLOCATING CURRENCIES - OPERATIONAL GUIDELINES

The Executive Board has reviewed the guidelines regarding the use of currencies in the operational budget as set out on pages 8-9 of EBS/90/113 (6/15/90) (Decision No. 9480-(90/103), adopted June 27, 1990), and decides that these operational guidelines shall continue to apply until the date on which the requirement for the effectiveness of increases in quotas under the Ninth General Review of Quotas specified in paragraph 3 of the Resolution of the Board of Governors No. 45-2 has been fulfilled, or in any event, until no later than December 31, 1992. (EBS/92/10, 1/22/92)

Decision No. 9917-(92/11), adopted
January 30, 1992

5. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 91/106 and 91/110 are approved.

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/92/16 (1/28/92) and EBAP/92/18 (1/29/92) and by an Advisor to Executive Director as set forth in EBAP/92/16 (1/28/92) is approved.

APPROVED: August 12, 1992

JOSEPH W. LANG, JR.
Acting Secretary