MASTER FILES

ROOM C-120 04

NOT FOR PUBLIC USE

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/8

10:00 a.m., January 13, 1986

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	J.-C. Obame, Temporary
	D. C. Templeman, Temporary
J. de Groote	H. G. Schneider
	G. Nguyen, Temporary
	N. Haque, Temporary
H. Fujino	
	W.-R. Bengs, Temporary
Huang F.	
J. E. Ismael	
	J. Hospedales, Temporary
	S. King, Temporary
H. Lundstrom	
M. Massé	G. W. K. Pickering, Temporary
	J. A. K. Munthali, Temporary
	C. A. Salinas, Temporary
	J. E. Suraisry
	L. P. Ebrill, Temporary
	J. de la Herrân, Temporary
	A. Steinberg, Temporary
C. R. Rye	
G. Salehkhou	O. Kabbaj
	A. S. Jayawardena
S. Zecchini	

L. Van Houtven, Secretary
J. K. Bungay, Assistant
S. J. Fennell, Assistant

Also Present

IBRD: J. Chaffey, Europe, Middle East and North Africa Regional Office. European Department: L. A. Whittome, Counsellor and Director; P. L. Hedfors, P. C. Hole, H. J. Huss, M. Z. Khan, A. Knöbl, G. F. Kopits. Exchange and Trade Relations Department: R. K. Abrams, J. T. Boorman, R. Pownall. Fiscal Affairs Department: G. Blöndal, L. Garamfalvi. Legal Department: H. Elizalde. Bureau of Statistics: B. Gurgen. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: I. Puro, A. Vasudevan. Assistants to Executive Directors: J. R. N. Almeida, K. Celebican, G. Ercel, S. Geadah, G. D. Hodgson, L. Hubloue, O. Isleifsson, M. Sarenac, B. Tamami, E. L. Walker.

1. TURKEY - 1985 ARTICLE IV CONSULTATION

The Executive Directors resumed from the previous meeting (EBM/86/7, 1/13/86) their consideration of the staff report for the 1985 Article IV consultation with Turkey (SM/85/332, 12/18/85; Cor. 1, 1/10/86; and Sup. 1, 1/8/86). They also had before them a report on recent economic developments in Turkey (SM/85/334, 12/23/85).

Mr. Zecchini remarked that Turkey's economy had shown an encouraging vitality in 1985, which had been spurred by the ongoing process of structural reform. GDP had increased briskly in 1985, but without negatively affecting the external accounts, thanks to a buoyant export performance that had been helped by the progressive liberalization of the exchange and trade system. The authorities had also achieved noteworthy progress in the rehabilitation of the state economic enterprises, which had improved their revenue performance and had reduced their use of budgetary resources as a ratio to GDP through a decrease in their borrowing requirements. However, further progress was still needed in that area, as recognized by the authorities. The overall financial policies had shown a certain degree of weakness and had been an important factor in the persistence of high inflation rates. The authorities had made slower progress in reducing the fiscal deficit than had been forecast due to deficiencies in tax collection as well as difficulties in reducing expenditures by the desired amounts. Noting that some measures had been taken by the Turkish authorities to reduce the public deficit, he wondered what the total impact of those measures would be on the fiscal position and whether they were sufficient to reach the fiscal target for 1986.

There had been strong growth in the monetary aggregates in 1985, and there still seemed to be excess liquidity in the economy, Mr. Zecchini considered. The authorities should assign a high priority to the tightening of monetary policy. Furthermore, better control of the monetary aggregates was necessary to reduce the inflation rate. Two interrelated problems facing the authorities were the imperfections in the control mechanisms used by the Central Bank and the excess liquidity in the economy. The instability of the reserve money multiplier had diminished the effectiveness of reserve money as an intermediate target, because controlling reserve money no longer guaranteed that larger monetary and credit aggregates could also be controlled. He asked the staff whether there would not be merit in shifting to M2 as an intermediate target.

The lack of timely information on net domestic assets of the banking system might also have hampered an accurate appraisal of monetary developments, Mr. Zecchini continued. The authorities should give priority to the development of a better statistical base covering the evolution of credit aggregates, as well as other monetary aggregates, such as M2. Other constraints on monetary policy had occurred because of the lack of secondary markets for government securities, which limited the possibility of open-market operations. That problem, together with the large size of the financial needs of the public sector, greatly constrained the authorities' room for maneuver in general, and their options for reducing excessive liquidity in particular. They should consider the possibility of increasing yields on new issues of government securities in order to promote greater absorption by the banking system as well as by private savers. In that connection, there was some justification for continuing to require banks to purchase government securities in amounts equal to their increase in deposits. That requirement should, however, be seen as a temporary measure to reduce liquidity; maintaining it for longer periods would cause distortions that could increase the cost of intermediation. Finally, given the current high level of liquidity, he wondered whether it would not be advisable to delay the programmed decreases in the reserve requirements.

He welcomed the further liberalization that had taken place in Turkey's exchange and trade policies, Mr. Zecchini stated. Flexible use of the exchange rate policy was especially advisable, as Turkey's exports and tourism receipts appeared to have been particularly sensitive to exchange rate movements. The composition of Turkey's exports had changed markedly in the past few years, with a rapidly increasing share having come from processed and manufactured products and a decreasing share from agricultural products. Although that shift might be a reflection of the change in the productive structure of the economy, exports of agricultural products had decreased steadily in absolute terms since 1982. Additional comments from the staff on that trend would be appreciated.

The medium-term scenarios indicated that Turkey would be able to combine sustained rates of economic growth with a viable external payments position, Mr. Zecchini concluded. The so-called growth scenario included what appeared to be an optimistic forecast for export growth, and the staff should elaborate on the underlying assumptions.

Mr. Massé commended the authorities on the notable achievements in 1985, particularly for having reached a point where further access to Fund resources was no longer required. During the seven years of adjustment--which had often been difficult--the outlook for Turkey had occasionally been grim, and considerable patience had been required by all the parties concerned. Nonetheless, Turkey currently had more or less returned to a viable, self-sustaining balance of payments position, thanks in no small measure to strong and continued adjustment policies supported by the Fund. Although not all of Turkey's performance targets for 1985 had been achieved, the authorities had made significant gains in some key areas: the current account deficit had continued to decrease, the capital account had strengthened, and inflation had decelerated markedly. Moreover, GNP growth had recently been revised upward to a healthy rate of nearly 5 percent. The authorities' current policy direction, which entailed an increasingly outward orientation and liberalization of the economy, had improved the long-term prospects for growth and diversification, and the revival of investor confidence, reflected in Turkey's renewed access to international capital markets, was particularly encouraging.

Nevertheless, a number of weaknesses had persisted, Mr. Massé added. The major uncertainties related to the excess liquidity in the economy and the conduct of monetary policy. Although inflation had moderated, a reversal of several special factors--such as the sharp decline in agricultural prices--combined with a buildup of liquidity, could lead to a resurgence of inflation. Money supply growth had clearly been too rapid and had not yet slowed appreciably. While a reduction in excess liquidity might impose short-term strains on the economy, it was nonetheless necessary to reduce inflation further. A sudden reversal in the trend of velocity might have serious implications for inflation, and it was therefore important not to lower interest rates in advance of a reduction in inflation and inflationary expectations. He welcomed the authorities' recent efforts to improve techniques of monetary control.

All three medium-term scenarios suggested that Turkey's debt service ratio would decline until 1990, although it would be at the high end of the manageable range, Mr. Massé observed. Substantial amounts of commercial bank borrowing would be required to finance the balance of payments over that period. However, he was troubled by the high-growth scenario, which indicated that the debt service ratio would increase after 1990. Even that scenario was based on the assumption of a 10 percent average growth in export volume. While the growth in exports in the past several years had exceeded that level, Turkey would have to increase its market shares for such growth to continue. Turkey's growth rate had been rapid over the years 1980-84 largely because it had captured untapped markets in the Middle East and North Africa and had increased its exports to OECD countries. Domestic conditions had also favored that growth, with low capacity utilization rates in export industries and depressed demand. The sensitivity analysis and scenarios had suggested that the authorites might have to accept less growth and more adjustment over the medium term if the external position were to remain viable. Maintaining a flexible exchange rate to ensure a competitive value for the lira would be necessary if export targets were to be attained.

The reductions in the budget deficit and the public sector borrowing requirement during 1985 had been encouraging, albeit somewhat short of the authorities' own targets, Mr. Massé commented. Further fiscal consolidation would be appropriate, particularly in view of the excessive liquidity in the economy. The revenue position in 1985 had not been as strong as projected, and he shared the staff's concern that attainment of the fiscal objectives for 1986 depended on a strong increase in revenues in two areas--corporate income taxes and the value-added tax--which might not be realized. The authorities would also have to monitor the extrabudgetary funds carefully to ensure that the funds did not reverse direction and become a drain on the budget. Earmarking taxes outside the budget might also reduce flexibility in setting fiscal policy.

A turnaround had occurred in the performance of the state economic enterprises, Mr. Massé noted with pleasure; the restructuring of those enterprises was continuing, and they might be able to make a positive contribution to the budget. He fully supported the more realistic pricing policies and the removal of certain subsidies to the parastatals.

He was encouraged that the Turkish authorities intended to remain in close touch with the staff during 1986, even though they did not wish to use Fund resources, Mr. Massé said. He hoped that the contacts would help Turkey to adjust quickly to changes in its circumstances, and that the authorities could thereby meet their ambitious economic goals.

Mr. Salehkhou said that the overall performance of the Turkish economy in 1985 had been satisfactory, with a relatively strong growth of GNP, a reduction in the rate of inflation, and a decline in the current account deficit. Despite a reduction in the growth of agricultural production, the most recent data indicated that real GNP had grown by about 4.9 percent in 1985--roughly in line with the target--reflecting a considerable expansion of industrial output. However, monetary expansion and budgetary performance were still a cause for serious concern.

The authorities had made an effort to liberalize the exchange and trade regime further in 1985, Mr. Salehkhou noted, including a shortening of the list of imports requiring prior permission, a notable rise in the number of goods that were importable after payment of a specific duty, the lowering of the average rate of import duty, and the abolition of the system of preferential export credits. In the light of those developments, Turkey's external economic performance seemed encouraging. The current account deficit had declined from $1,070 million to $514 million in the first ten months of 1985, due largely to the doubling of tourism receipts and the decline in the trade deficit, which in turn reflected the pickup in exports and slowing of import growth. The capital account, however, had recorded a significant increase in foreign short-term debt. Although a considerable portion of that debt represented foreign exchange deposits that were used, through the Dresdner Scheme, to finance trade on highly concessional terms and were not regarded by the authorities as fully comparable with external debt, the continuation of such short-term inflows could translate into a considerable weakening of the balance of payments. Thus, careful monitoring and adoption of corrective measures appeared necessary.

Although the rate of inflation had decelerated during the second and third quarters of 1985, reflecting favorable agricultural prices, inflationary pressures had continued to be strong throughout the year, and the inflation rate had been higher than targeted for 1985, despite the decline in the rate of monetary growth from 74 percent in 1984 to about 63 percent in 1985, and the authorities' attempt to contain such growth by weekly auctions of one-year government bonds to commercial banks and other financial institutions, Mr. Salehkhou pointed out. While the authorities' introduction of several institutional changes to control monetary expansion appeared to be steps in the right direction, they should be watching for a possible resurgence of inflation.

The ratio of total expenditures to GNP had continued to decline, but real expenditures had not been contained sufficiently to offset a further shortfall in the collection of direct taxes, Mr. Salehkhou commented. Thus, the authorities' earlier objective of a balanced budget in 1985 had not been attained, and the budget deficit was currently expected to reach 2.3 percent of GNP. The authorities believed that they could improve their income collection in 1986, aided by revenue information that was being obtained through the value-added tax collections. However, over the medium term, the Government needed to increase the revenue base not only to curb the deficit but also to mobilize adequate resources for necessary investment expenditures. The state economic enterprises had performed relatively well in 1984 and 1985; they had generally recorded profits, and transfers from the budget to the public sector enterprises had declined both in relation to GNP and in absolute terms. The authorities' commitment to privatize a number of the parastatals to improve their efficiency was laudable, but they needed to make further attempts to enhance the attractiveness of those enterprises to the public at large.

The authorities' projections for 1986 of GNP growth of 5 percent, an inflation rate of about 25 percent, and a current account deficit of $700 million appeared optimistic, Mr. Salehkhou considered. He asked to what extent the potential inflationary pressures from the existing excessive domestic liquidity had been taken into account. The projections also implied a continued gain in Turkey's export market shares, yet in view of the sizable share that the two oil exporting neighboring countries represented in Turkey's external trade--about 25 percent--any further decline in international oil prices could have a considerable effect on Turkey's exports to those neighbors. Similarly, the continuation of protectionist measures already imposed by many industrial countries against a number of Turkey's exports would adversely affect such projections, especially with respect to import and output growth. Staff comments would be helpful.

Turkey's relationship with the EEC was of interest, especially after the membership of the EEC had been increased by the entry of Spain and Portugal, Mr. Salehkhou said, and he requested comments on the recent reports regarding the likelihood of Turkey's application for full membership in the EEC. Finally, he congratulated the authorities for having introduced new policy measures, effective January 1, 1986 in the external, monetary, and fiscal areas.

Mr. Huang commented that the Turkish economic adjustment program, which had been supported by the Fund, had scored considerable achievements in output growth, the external accounts, and structural reform since 1980, except for a somewhat poor performance in 1983. Thus, for the first time in seven years, the authorities did not need to seek further access to Fund resources after the 1985 Article IV consultation, which was an encouraging sign of progress.

However, Turkey still faced problems and uncertainties in the monetary, fiscal, and external areas, Mr. Huang noted. Improvements in the external sector would be essential to the success of the Turkish economic adjustment in 1986. It was not clear to him whether the authorities would be able to achieve sufficient improvement in the balance of payments in 1986, however, because that would require not only their efforts, but also a normal international environment, which had been increasingly jeopardized by protectionism. In recent years, the authorities had been liberalizing the exchange and trade regime, especially imports, but Turkish textile exports, for example, had fallen by 18 percent in value in the first half of 1985 due to protectionist pressures. The Turkish balance of payments might suffer if the authorities continued to push the liberalization of imports while exports were heavily hindered by protectionism. He was not proposing to reverse the Turkish liberalization of trade; protectionist pressures abroad should be curbed. The authorities needed the full support of the international community, especially Turkey's trading partners in the industrial world, to ensure a sufficient improvement in the balance of payments in 1986.

The authorities were determined to continue pursuing tight monetary and fiscal policies for 1986 with the aim of further reducing the inflation rate and improving the balance of payments, Mr. Huang continued. Those aims and policies were desirable, but their impact on the level of employment was not clear. Narrowly defined, the unemployment rate in Turkey had reached 6.1 percent in 1984, compared with 4.2 percent in 1980; more broadly defined, the level of unemployment--or labor surplus--had reached 16.5 percent in 1984, compared with 14.8 percent in 1980. Thus, importance should be attached to the impact on unemployment of the proposed tighter policies for 1986, because that would determine to some extent how far the tighter monetary and fiscal policies could be pushed.

Mr. Fujino said that in the past two years there had been contrasting results in the two main areas of concern--the external balance and the rate of inflation. The external balance had improved, with the current account deficit having been reduced by $500 million in 1984 to $1.4 billion. It was estimated that the deficit in 1985 would decline further to $0.8 billion, or 1.5 percent of GNP. Imports had increased rapidly--by 17 percent--in 1984, but the balance of payments had still improved because of a sharp rise in exports, tourism revenues, and workers' remittances. The favorable outcome of exports seemed to have been supported by the revival of world trade in general and the strong demand in Turkey's trading partners in particular, as well as by the maintenance and promotion of the strong competitive position of Turkish exporters through the flexible adjustment of the exchange rate and other policy incentives. Although debt relief had been phased out, the improved confidence of the international capital markets in the Turkish economy had restored some of its access to normal capital inflows. That was an encouraging example of how successful adjustment efforts of heavily indebted countries, assisted by favorable external circumstances, helped the countries regain more normal access to the international capital markets.

The Turkish external balance remained weak, however, Mr. Fujino added. The current account was still in considerable deficit, and the external debt service burden over the coming years would be heavy. The external conditions for Turkish exports were expected to be less favorable. Turkey's progress in import liberalization ought to give rise to a positive response from its trading partners, although that would make its external balance more vulnerable to economic fluctuations. Continued efforts to maintain the competitiveness of Turkish exports, through structural reform and flexible management of the exchange rate, would be essential to maintain a stable external position.

The inflation performance had been very disappointing, Mr. Fujino said. The rise in the rate to as high as 50 percent in 1984 had been alarming. The root cause of the high rate of inflation was the financial policies of 1983, as well as the considerable price adjustments by the state economic enterprises. Fiscal and monetary policies had been more disciplined recently, and the rate of inflation had moderated. Nonetheless, the programmed rate of inflation of 25 percent for 1986 seemed to be high.

In spite of the weak performance of revenue, the budget deficit had been contained in 1985, compared with the high level in 1984, although largely because of the reduction of investment, which might not be consistent with the goal of strengthening of the competitive position of industry, Mr. Fujino noted. The improvements in tax administration, including the newly introduced value-added tax, was important, but he was concerned about the authorities' intention to use information gathered from the value-added tax collections for income tax purposes; experience had shown that, instead of strengthening the tax administration, such an effort tended to weaken materially the implementation of sales taxes because of the increased incidence of tax evasion. Comments from the staff on that point would be helpful.

The rapid growth of money was another major cause of the high rate of inflation, Mr. Fujino considered. If the slowing of the velocity of money was to be reversed, the growth of the monetary aggregates must be watched closely. Announcing the M2 target, revising it quarterly, and holding a monthly review of the interest rate on deposits would be conducive to the improved monitoring of monetary developments. He shared the concern of other Directors regarding the course of monetary growth and urged close monitoring in the future. The authorities had recently implemented changes and reforms to improve the management of monetary policy; he asked the staff whether market-based instruments were sufficiently effective to control monetary growth or whether some direct measures might be needed. Moderation of wage and salary increases would also be a useful tool in the fight against inflation, and more flexibility in labor practices would help alleviate rigidity in the labor market.

Mr. Haque noted that economic growth in 1985, although somewhat lower than in 1984, had remained at the satisfactory level of about 5 percent, while the continuation of rapid growth in exports, along with a slowdown of growth in imports, had led to a sharp reduction in the current account deficit. Accordingly, Turkey--which for several years had been dependent on debt relief--had been able to re-establish normal payments to its creditors in 1985. Meanwhile, the authorities were appropriately carrying forward their adjustment policies, including a continuation of the efforts that had been initiated under the Fund-supported program that had ended in December 1984: the trade system had been liberalized further, so that few quantitative restrictions remained; the exchange rate had been flexibly managed to preserve external competitiveness; and to achieve revenue growth, a comprehensive value-added tax system similar to that of EEC members had been implemented early in 1985.

However, no long-term solution had been found for some persistent problems, which underscored the need for further corrective measures, Mr. Haque pointed out. In particular, the rate of inflation remained high and could accelerate, given the liquidity overhang that had resulted from the rapid monetary growth of the past two years. Moreover, additional revenue needed to be generated, in combination with better control of expenditures, to reduce the budget deficit to levels that were more conducive to the credit conditions in the economy.

The acceleration in the growth of the monetary aggregates over the past two years had been attributed mainly to a combination of the improvement in the balance of payments and the autonomous increase in the reserve money multiplier, Mr. Haque recalled. Moreover, reserve money could not be contained within targeted levels because of sales of foreign exchange to the Central Bank by commercial banks. While he agreed largely with the staff's analysis of monetary developments, he asked for clarification of the staff's position on the sterilization of foreign exchange inflows as a possible response in such situations.

Table 9 of SM/85/332 indicated that the money multiplier had increased between 1983 and 1984, but had apparently remained stable or had declined somewhat between 1984 and 1985, Mr. Haque stated. The data in Table 9 lent some support to the hypothesis that the acceleration in monetary growth in 1984 had resulted partly from an autonomous increase in the money multiplier, but it was difficult to reconcile the data in Table 9 with the assertion on page 8 of SM/85/332 that the rapid growth of money in 1985 was attributable to another increase in the money multiplier.

The authorities had appropriately fixed relatively ambitious targets for restraining money growth for the coming year, with M2 targeted to grow by less than 40 percent, Mr. Haque continued. Thus, reserve money would remain the principal operational target that would be monitored on a continuous basis. However, the staff report had alluded to difficulties in restraining the growth of various components of reserve money, and he wondered if the staff could elaborate on some of those difficulties and indicate how they might affect the use of reserve money as a principal operational target. Moreover, he also wondered whether some other monetary aggregate might be a better target.

The medium-term scenario showed that it was possible for Turkey to attain relatively rapid growth along with external viability, especially if the recent strong growth in exports was maintained, Mr. Haque concluded. That conclusion was in keeping with the authorities' export-led growth strategy in support of which many significant changes had been made, including the maintenance of a liberal exchange and trade system. It was both regrettable and unfortunate that Turkey's substantial adjustment efforts were being adversely affected by protectionist pressures in industrial markets.

The Director of the European Department agreed with Mr. Dallara's remark that in a general sense Turkey had been the first country to have implemented some of the broad ideas put forward within the framework of the Baker initiative, but pointed out that Turkey had been given a substantial degree of financial assistance by the international community. In 1980, Turkey had arranged an unprecedentedly large stand-by arrangement with the Fund, and had received a total of $3.6 billion in international assistance. That financial assistance had covered the total of debt maturities due in 1980 as well as the interest on the total external debt, and it had provided nearly $1 billion in surplus funding, thus enabling Turkey to allow imports to increase. The 1980 program of the Turkish Government had been introduced against a background of political stability that had not existed for the preceding four or five years. The opening up of the Turkish economy had been on a gigantic scale. In the late 1970s, Turkey had been one of the most closed economies in Europe in terms of external trade. That situation had changed dramatically, with exports having risen from less than 5 percent of GNP in the 1970s to about 15 percent currently. Moreover, the degree of cooperation between the Fund and the World Bank--and, more importantly, between the Turkish authorities and the World Bank--had been substantial, and the World Bank had had a large involvement in Turkey. Finally, Turkey had made wide-ranging improvements in its statistical base, especially including data on prices, the balance of payments, and monetary and fiscal developments. Without those improvements, some of the changes made in the Turkish economy would have been less well based.

Mr. Huang's point about the dangers to Turkey of protectionist measures taken by its trading partners in Europe and in North America was well taken, the Director observed. Mr. Salehkhou had correctly warned that the changing climate and the threat of slow growth in the Middle East would not be helpful to Turkey. Nonetheless, it was important to remember that, although the Middle East took one third of Turkish exports, those exports represented less than 3 percent of Middle Eastern imports. Furthermore, it was thought that no more than 7 percent of the Turkish workers living abroad were located in the Middle East.

The short-term external debt problem had two facets: its implications for monetary policy and the debt problem itself, the Director pointed out. On the monetary side, the variability in short-term capital inflows was a complicating factor, but some instruments to cope with it were now in place. On the external side, however, experience in a number of countries had led the staff to believe that short-term external debt taking the form of foreign exchange accounts could, in adverse circumstances, become a massive problem. Thus, the staff had learned to be wary about such debt.

The difficulties experienced in implementing monetary policy in Turkey, the Director continued, could be traced to two factors. The first was the climate in which monetary policy had to work, notably the complicated situation introduced by the variability in the foreign exchange inflows. Second, and most important, was the continuing large public sector deficit. The monetary problem in Turkey could be characterized as a manifestation of a budgetary problem. The authorities were fully capable of introducing the necessary techniques to control the situation, given adequate action on the budgetary side.

As far as he knew, the Director of the European Department said, the question of Turkey's membership in the EEC was still being discussed. No measurable progress had been made recently.

The staff representative from the European Department indicated that excess liquidity had arisen at the end of 1985 largely because of the exclusion from the broad money aggregate, M2, of foreign exchange deposits with commercial banks. The accumulation of foreign exchange deposits, totaling about 15 percent of M2, was attributable to active currency substitution by depositors and the banking community. If that currency substitution coefficient approximated unity, then broad money, including foreign exchange, M2X, should be counted as the most comprehensive measure of liquidity. The authorities' 1986 monetary target for broad money--a 35 percent growth rate, with a real interest rate on time deposits of about 10 percent--was generally adequate, but the target ignored the foreign exchange deposit component of broad money. It was not clear whether the recent measures to contain the probable rise in foreign exchange deposits would be sufficient. It did not seem that they would enable the authorities to achieve the targeted 35 percent growth in M2X, because the new reserve requirements for foreign exchange deposits were simply a substitution for the minimum cover requirement of 20 percent that had been in force previously, and because it was still about 30 percent cheaper for the banks to lend from foreign exchange deposits than from Turkish lira deposits. Thus, the banks continued to be biased toward currency substitution. Similarly, individual depositors recognized that the interest yield of foreign exchange deposits was taxed only at the 1 percent withholding tax, as opposed to the 10 percent tax on the yield on domestic currency deposits. In sum, the recently imposed reserve requirements on foreign exchange deposits would probably not help to contain the growth of the foreign exchange deposit component of M2X.

With regard to monetary control through base money, it was encouraging to note that reserve money had declined from the end of September to early December 1985, indicating that the authorities could at times sterilize the potential increase in reserve money out of excessive accumulation of net foreign assets, particularly by containing the financing of the deficit, the staff representative added. However, the question remained as to the extent to which such an operation on the reserve money itself could continue or, in other words, what would be required to bring about a 35 percent growth in M2 during 1986, if the reserve requirement ratio was reduced by 4 percentage points during that period.

A number of Executive Directors had suggested that a shift from reserve money to a broader aggregate, namely the net domestic assets of the banking system as a whole, should be acted upon as an operational variable, as was being done in a number of countries, the staff representative recalled. The statistical problem of reporting on time had posed difficulties in Turkey, but that was expected to be solved sometime in 1986. A Fund technical assistance mission would be going to Turkey in February 1986 to look at the monetary data in the light of the recent banking reform and the external liberalization that had taken place at the beginning of 1984. The technical data problem might be solved, therefore, but the monetary authorities had reservations about using as a ceiling net domestic assets for the banking system as a whole, because of the costs that that was likely to impose on the allocation of financial resources. Moreover, the authorities did not yet have any of the necessary market tools within the banking system, such as an active interbank market or open-market operations. In addition, there were a number of potential leakages in such a system, as had been demonstrated by the experience of other countries.

It was doubtful that the goal of reducing the public sector borrowing requirement and the consolidated deficit to the targeted levels would be fully realized, primarily because of revenue-side difficulties, the staff representative commented. The measures taken early in 1986 had improved the revenue outlook, but the problems related to advance payments and inadequate receipts remained, and there was still a question about the ability of the Government to bring in the necessary revenue. However, the Government's welcome resolve to freeze authorizations up to 8 percent of the amount specified in the budget as a contingency measure meant that if there was a revenue shortfall of up to LT 200 billion, roughly that amount could be reduced on the expenditure side. As alluded to by a number of Executive Directors, there was indeed a potential problem with the extrabudgetary funds, but the Turkish authorities were committed to use those funds prudently and in harmony with the fiscal policy objectives.

Although there was no formal incomes policy in Turkey, the activity of the High Arbitration Commission in setting guidelines that were mandatory for public sector wages and strongly indicative for the private sector might be interpreted as a workable form of incomes policy, the staff representative mentioned.

Responding to Mr. Dallara's question on the relative importance of the recent shift to the free list of a number of goods from the list of imports subject to import licensing, the staff representative said that no precise information was available about the value of those imports, but that after the trade liberalization measures taken by Turkey in 1984 and 1985, the share of goods subject to licensing had declined from about 80 percent in 1983 to about 25 percent of total imports in 1985. The authorities were planning further trade liberalization, and had scheduled further reductions in the rate of export tax rebates and intended to reduce the advance import deposit requirements to zero within the next few years, depending on the circumstances.

The World Bank had contributed very usefully to structural reform in Turkey, providing both financial and technical assistance since 1980 to help the authorities strengthen trade policy, reform the tax and banking systems, and streamline the public enterprises, the staff representative noted. The very nature of those long-term, structural measures required much preparation and design as well as many studies, and, accordingly, the nature and timing of the conditionality of the World Bank structural adjustment loans differed from Fund conditionality. The World Bank was also involved in the effort toward privatization, both by a comprehensive approach to the privatization of the public enterprises and by the conduct of pilot studies in the areas of textiles, fertilizers, and cement to determine the feasibility of eventually selling those entities to the private sector. Finally, the World Bank was preparing a financial sector adjustment loan to help the authorities implement additional financial structural reform measures.

The Turkish authorities were preparing to activate the interbank market, the staff representative continued. Preliminary reductions in the transaction tax rate had taken place, but further efforts would be made by the Central Bank to intermediate interbank transactions, in order to protect the anonymity of participating banks. The authorities expected to make progress in open-market operations in the future, but first it was necessary to activate a secondary market for government paper. As a first step, the authorities had begun auctions during the past year vis-à-vis commercial banks and financial institutions, which had been successful in the sense that they had provided some market indication as to the appropriate market interest rate for six-month, one-year, and two-year government securities.

The medium-term "growth" scenario hinged on the same behavioral and technical relationship assumptions and the same underlying data and projections as did the other scenarios, the staff representative commented. The only difference was that the annual growth rate was an objective in the calculations, taken directly from Turkey's five-year plan. That plan was viewed as an indicative one that would be approached and approximated, if conditions allowed. In that regard, the plan was to be revised year after year to reflect current conditions, particularly external constraints, and was not something that the Turkish authorities intended to pursue rigidly and mechanically.

Relevant to the medium-term scenarios, but more particularly for 1986, was the potential impact of the oil price decline on the trade balance and the external current account, the staff representative pointed out. Indeed, the decline in oil prices could affect Turkish exports to Middle Eastern countries, but experience over the past few years suggested that the impact of any oil price decline would bring much greater benefit, in terms of a lower oil import bill, than costs, in terms of the decline of exports to Middle Eastern countries. That was because Turkey was exporting a number of products--for example, foodstuffs and clothing--for which there was relatively inelastic demand, irrespective of income levels in those countries.

The composition of Turkish exports--particularly industrial exports--had remained unchanged over the past few years, and the authorities were aware of the need for diversifying exports, the staff representative stated. They had changed the system of subsidies to industrial exports, from credits that had been provided for anyone applying for loans that would eventually be used for export activity, to a system whereby the subsidies were provided as a percentage of exports that had actually taken place. In addition, infrastructure investments were being made in various activities that should increase exports over the coming years. The authorities were also expecting the flexible exchange rate policy to foster more activity in the export sector.

While he understood the concerns expressed about the potential impact of tight monetary policies on employment, the staff representative from the European Department recalled that, in general, whenever the Turkish authorities had pursued prudent financial policies, growth had followed. Consequently, the prevailing view in Turkey was that by pursuing such policies, the authorities would be able first to contain and then to reduce unemployment.

The staff representative from the Exchange and Trade Relations Department stated that the Turkish authorities viewed the short-term foreign exchange deposits as an inflow of exchange that would be converted to local currency in the future, which therefore made them less risky than other short-term borrowing. As the staff did not fully share the authorities' view, those short-term external debts were a recurring topic of discussion. It was not easy to generalize about the monetary control implications of the situation, because they differed according to the special relations that were established between the commercial banks and the Central Bank in the treatment of those deposits. What the staff had often tried to suggest, though, was that those arrangements should at least be neutral, without the banks providing incentives to encourage an inflow of such short-term deposits. Nonetheless, it was at times cheaper for the banks to fund domestic loans through foreign inflows than to raise those funds domestically. It was equally true that, in terms of exposure, such short-term external debts became a problem whenever a crisis arose in a country, and it was difficult to predict or prepare for such a situation. Given the implications of the short-term foreign deposits, the staff tried to make sure that those deposits were included in the external debt statistics and that the interest credited to those deposits was included in the calculations of the total debt service ratio. Finally, on the currency substitution issue--regardless of exposure and risk--it was of concern that a number of member countries had recently had such a large increase in the foreign exchange currency component of the domestic money supply. For example, in Yugoslavia it represented about 50 percent of the money supply. Unfortunately, that was no longer unique because many countries had deliberately instituted programs to encourage the inflow of such foreign-currency-denominated deposits. In such situations, the staff did its best to have the authorities think in terms of true arbitrage interest rates on domestic-currency-denominated monetary assets. It was necessary to exploit the foreign exchange availability, which was reflected in the immigrant earnings overseas. In a sense, it was not possible to have it both ways, namely, an inflow of those deposits as well as protection while the deposits were being used. Consequently, the staff wanted to encourage expatriates to convert their earnings into local currency, which required not just positive real interest rates, but real interest rates on domestic assets at full arbitrage levels and perhaps even at a premium to induce holdings of the local currency. Thus, in Turkey, one important issue was to make sure that interest rates were held positive in real terms, which had not always been the case and had induced the public to seek the added protection afforded by foreign exchange deposits.

Mr. de Groote observed that the Executive Board had consistently shown its confidence in Turkey's endeavors during the several years it had had the benefit of Fund assistance and, at the same time, its constructive criticism and suggestions had helped Turkey to realign its policies whenever needed. Turkey's "graduation" from the Fund programs had provided some lessons with broader applicability. The success of a program to improve the balance of payments position depended greatly on its nongradual stance and on the acceptance from the very outset of measures aimed at structural reform. When such measures formed an integral part of the program, the policies advocated by the Fund were conducive, not detrimental, to growth. Prolonged use of Fund resources was justified when it was necessary to implement far-reaching corrective actions over an extended period.

The Executive Board was currently focusing attention on the resources needed to support a development-oriented strategy, especially in countries that had successfully implemented their stabilization program, Mr. de Groote continued. Hence, Turkey's success should provide a kind of certification to the international financial markets, but he hoped that no misunderstanding would arise about the implications of its success. Turkey was not on the list of countries covered by the Baker plan, which only included countries that had experienced difficulties in gaining access to the markets. Turkey's efforts would be penalized, and the very purpose of the Baker plan would be thwarted, if the restoration of lending to some countries took place at the expense of other countries which, like Turkey, had already re-established by their own efforts the conditions for spontaneous access to the markets.

Success was not seen in Turkey as a reason for complacency, Mr. de Groote noted. The authorities would be facing four major tasks in the years ahead: reducing inflation, improving further the financial position of the public sector, limiting the increase of short-term debt, and expanding external savings to the extent needed to obtain the desired rates of growth in income and employment.

The authorities had recognized that the disappointing performance of prices in 1984 could not be ascribed exclusively to corrective adjustment, but should also be attributed to the excessive expansion of liquidity and the increase in the budget deficit, Mr. de Groote indicated. They had thus taken steps in 1985 to reduce the monetary financing of the public sector, and the growth of the monetary aggregates was indeed declining, due in part to the higher than expected proceeds of the value-added tax. However, one should not underestimate the difficulty of implementing a policy of monetary contraction, as direct action on the domestic assets of the banking system was not yet feasible. Control of the monetary aggregates had to occur through action on reserve money, but the reserve money multiplier was highly volatile. Thus for 1986, the authorities were committed to a policy of positive real interest rates, rapid adjustment of central bank credit to the public sector whenever needed to obtain the monetary targets, and measures to offset the monetary effect of capital inflows, such as the current 20 percent legal reserve requirement on foreign exchange deposits. Mr. Zecchini's suggestions to organize a secondary market for government securities and to increase the yield on the issue of such securities might be a useful contribution to those efforts. Having a better understanding of the need and ways to monitor internal liquidity closely, the Turkish authorities were confident that the 25 percent inflation objective for 1986 could be achieved. The figures for December 1985 were encouraging in that respect: the wholesale price index had increased by 1.9 percent, and the consumer price index had dropped by 0.4 percent.

Two basic public finance objectives had been set for 1986--a budget deficit of 1.3 percent of GNP and a public sector borrowing requirement of 3.9 percent--but it was his view that the outcome would be better than projected, Mr. de Groote advised, because of the better than expected results of the value-added tax, and because of the progress under way in the state economic enterprises. Virtually, all the state economic enterprises had become financially autonomous. Moreover, foreign competition was currently intense in the areas that had traditionally been reserved for the state economic enterprises: for example, foreign competition had led to reorganization and improved efficiency in tobacco production and distribution.

With debt relief having been phased out, the impact of external debt reimbursement was a factor to consider in any assessment of the role of monetary policy and fiscal performance in Turkey, Mr. de Groote pointed out. The impact of repayments of principal and interest on public and publicly guaranteed debt had been massive. The ratio of gross principal and interest repayments to total budget revenue had increased from 4 percent in 1981 to 18 percent in 1984 and to 21 percent in 1985, which should not be ignored when judging the performance of Turkey's economy, especially the budgetary performance and the evolution of monetary aggregates.

Countries that were still enjoying the benefit of debt relief should be aware that after the phaseout of such relief, the impact of repayments might be much stronger on budgetary and monetary aggregates than on the balance of payments.

The increase in short-term debt in the form of foreign exchange deposits was clearly a reflection of increased confidence in the Government and its economic policies, Mr. de Groote commented. It would have been irrational for the Turkish authorities to refuse an inflow of liquidity of about $3 billion or to prefer that those funds be spent abroad. The authorities had rightly explained that that amount had to be excluded from the foreign debt. Except for the Dresdner Scheme deposits, held in the Central Bank, all other types of foreign exchange deposits were subject to the reserve requirements. The Turkish authorities intended to monitor the situation with great care. To prevent withdrawals, it was essential to avoid any measures that would give the depositors the impression that they were trapped in the system. The risk of precipitous withdrawals was, however, minimal under the current political and economic conditions. Indeed, those deposits had been extremely stable over time, depending primarily on the number of Turkish workers abroad, currently more than 800,000, or 5.5 percent of the labor force.

The needed increase in savings, which would enable Turkey to reach the output and employment targets set for the medium term, was the most critical element on which Turkey's prospects rested, Mr. de Groote considered. The current savings ratio--about 18 percent of GDP--was already high. The Turkish authorities expected positive results from the introduction of new savings instruments, such as the Keban Dam and Bosporus Bridge bonds; the organization of a full-fledged capital market that was currently under way; the recent opening of the Istanbul Stock Exchange; and the progressive reduction and elimination of the dissaving of the public sector. It had been unavoidable that the reallocation of resources from internal absorption to the balance of payments had coincided initially with an increase in unemployment and a reduction of income for workers and government employees. Even a modest increase in the savings ratio might be sufficient to sustain later income growth if, in the next few years, the rate of increase in income remained high under the influence of market-oriented and outward-looking reforms and increased direct investments from abroad. The staff's medium-term central scenarios for external debt and the balance of payments were revealing: they showed that a high rate of income growth, 5 3/4 percent during the period 1987-90, was compatible with an 18 percent debt ratio, against the current 28 percent, and with a small current account deficit--0.7 percent of GNP--that could easily be offset by long-term direct capital inflows. The wide-ranging measures adopted in December 1985 were all intended to deregulate certain aspects of the economy: import restrictions had been dismantled further, the price system had been liberalized, the state economic enterprises had begun to operate autonomously, and interest rates had begun to respond to market forces. The reinforcement of such elements of competition and openness to the outside world was the best guarantee for Turkey's ability to achieve the ambitious objectives in its medium-term scenario.

Such competition and openness would also help reduce unemployment, an important objective rightly stressed by Mr. Huang, but that could only be attained if income growth stayed close to 6 percent over the 1987-90 period.

To maintain the benefit of the Fund's advice in 1986, Mr. de Groote concluded, the Turkish authorities wished to establish a new relationship with the Fund, which implied voluntary monitoring on a more frequent basis than would occur under the regular Article IV consultation, and which also implied technical assistance on a more fundamental macroeconomic level than would be customary under the usual technical assistance missions. By such an arrangement, the Fund would carry out one of its most important responsibilities--that of providing technical assistance to its members to help them formulate appropriate global policies.

The Chairman made the following summing up:

> Executive Directors noted that after the setback in the stabilization effort in 1983 and the limited improvement in economic performance in 1984, Turkey had made important progress during 1985 in strengthening the balance of payments, reducing inflation, and maintaining a satisfactory rate of economic growth.
>
> Directors warmly commended the Turkish authorities on those important results. They particularly welcomed the continuing improvement in Turkey's external payments position during 1985, based on better performance in both merchandise trade and services. The further reduction in the external current account deficit was attributed for the most part to a combination of a flexible exchange rate policy and further liberalization of the exchange regime. Directors praised the authorities' perseverance with the import liberalization program, particularly at a time when unfortunately Turkish exporters faced trade restrictions abroad. Directors hoped that Turkey would continue to pursue policies that would lead to a further strengthening of the external position in 1986, in a climate marked by less protectionism.
>
> Directors were encouraged to note that, despite the absence of debt relief for the first time in several years and despite a reduction in financing from official sources, Turkey had been able to service its external debt obligations fully in 1985 without reducing foreign exchange reserves. That result was seen as reflecting the growing creditworthiness of the economy and the confidence of the commercial market in the authorities' endeavor to attain external viability. While it was recognized that an important proportion of short-term capital inflows in 1985 reflected greater utilization of trade credits to finance expanding trade as well as a strong response to the foreign exchange

deposit scheme, the authorities were cautioned against an excessive accumulation of short-term liabilities and urged to build adequate reserves to meet possible unexpected capital outflows.

Directors noted that after a disturbing acceleration in the rate of inflation during 1984 and again in early 1985, the rate of rise in prices had slowed perceptibly in the second and third quarters of 1985, in large part as the result of favorable agricultural supplies. While Directors welcomed the turnaround, speakers generally were much concerned not only that the recent improvement could reverse itself but also that the rapid growth in money supply during 1985 risked contributing to renewed demand pressures, thus fueling inflation once again. In that context, Directors generally were not convinced that monetary policy was adequately tight to control the excessive rate of monetary expansion, and they stressed the critical need to curtail that expansion sharply in 1986. Toward that end, it would be important for the authorities to continue a flexible interest rate policy aimed at maintaining positive real interest rates and to monitor credit developments very closely, aided by a strong, up-to-date statistical base. In addition, a number of Directors felt that it would be prudent to delay planned reductions in reserve requirements until more effective control had been established over the growth of reserve money.

Directors also stressed the role that fiscal policy should and could play in easing inflationary pressures. While speakers welcomed the successful introduction of the VAT and the strong improvement in the financial performance of the state economic enterprises in 1985, they noted that the reduction in the central government consolidated budget deficit had been much less than originally hoped. While the public sector borrowing requirement had been reduced significantly, it remained uncomfortably large; as such, it hampered the implementation of the much needed tight monetary policy and absorbed a large share of scarce financial resources. Particular concern was expressed about the continued lack of buoyancy of direct tax revenues, and a number of speakers questioned whether the targeted reduction in the budget deficit in 1986 could be realized without additional revenue measures and further restraint in nonessential current expenditures.

Directors also underscored the need for the authorities to exercise strict control over the newly introduced extrabudgetary funds to ensure that their operations did not run counter to the overall budgetary policy and to further reduce the aggregate financing need of the state economic enterprises.

Directors emphasized that comprehensive adjustment policies had been implemented over the last several years. Those policies had included a substantial opening up of the economy and a correction of a number of structural as well as financial weaknesses.

It was also recalled that such policies had been strongly supported by many Fund members as well as by the Fund and the World Bank.

Among the policies implemented, Directors welcomed in particular the substantial liberalization that had occurred in both external and domestic trade and the fact that the important state economic enterprise sector had been subjected to more effective financial control. They considered that those changes had improved the prospect of continued satisfactory rates of growth in the future. However, referring to the medium-term balance of payments scenarios for Turkey, which demonstrated the continuing vulnerability of the external position, Directors stressed that the feasibility of Turkey's achieving such rates of growth, while preserving a viable external payments position, would hinge on the resolute pursuit of the adjustment strategy, including prudent demand management and the maintenance of a realistic exchange rate, supplemented with structural measures aimed at further enhancing the country's export capacity and mobilizing domestic savings.

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

The Executive Board then took the following decision:

1. The Fund takes this decision in concluding the 1985 Article XIV consultation with Turkey, in the light of the 1985 Article IV consultation with Turkey conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Turkey maintains exchange restrictions under the provisions of the Fund's Article XIV. The Fund welcomes the continued liberalization of the exchange and trade system described in SM/85/332. The Fund urges Turkey to terminate the remaining bilateral payment arrangement with a Fund member as soon as possible.

Decision No. 8182-(86/8), adopted
January 13, 1986

2. ICELAND - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Iceland (SM/85/333, 12/19/85; and Cor. 1, 1/17/86). They also had before them a report on recent economic developments in Iceland (SM/85/339, 12/30/85; and Cor. 1, 1/17/86).

Mr. Lundstrom made the following statement:

Following the recession of 1982-83, Iceland is back on a path of economic growth. Real GDP rose by 3.1 percent in 1984 and is estimated to have risen by 2.5 percent in 1985. Further growth--albeit modest--is envisaged for 1986. The Government's policies to bring down inflation, which, at annualized rates, rose to about 130 percent in mid-1983, met initially with great success, although wage agreements negotiated in the fall of 1984 and June 1985 resulted in a higher rate of inflation for 1985 than was envisaged. The cost of living index rose by 34 percent during 1985. Although the original targets in this area have not been fully achieved, this figure reflects substantial progress from the situation two and a half years ago when the economy was wrestling with a three-digit iflation rate.

One of the most worrying aspects of recent economic developments has been the persistence of the deficit on the current account of the balance of payments. The current account deficit in relation to GDP fell from 8.4 percent in 1982 to 2.0 percent in 1983, rose again to 5.1 percent in 1984 and is estimated to have declined to about 4.7 percent in 1985. In recent years, these deficits have mainly been caused by large interest payments on the foreign debt, resource limitations imposed, particularly in 1982 and 1983 on important fish catches, and, finally, by difficulties in adjusting domestic demand to changes in external circumstances.

Total long-term foreign debt increased from 52.2 percent of GDP at the end of 1984 to 54.8 percent at the end of 1985, whereas debt service declined from 24 percent to slightly less than 21 percent of export earnings. Lower international interest rates and increased exports are the main factors behind this decline in the debt service ratio.

The employment situation was satisfactory in 1985 with the average unemployment rate for 1985 estimated at 1 percent of the labor force, compared with 1.3 percent in 1984 and 0.6 percent, on average, for 1979-83.

My authorities recognize that a balanced fiscal budget is a prerequisite for economic stability. As the outcome for the Treasury was worse than envisaged in the 1985 budget, expenditure cuts and other ways to eliminate the deficit became urgent. The original 1986 budget proposal--which was characterized by retrenchment of expenditures--was revised in November to effect further net expenditure cuts, along with measures providing for an improved balance on the state lending and relending account. These actions permitted a reduction in the planned foreign borrowing by the Treasury of ISK 0.5 billion. Moreover, foreign borrowing by public entities outside the budget was cut by ISK 0.3 billion. Thus, this revision of the 1986 budget proposal resulted in a cut in planned foreign borrowing by the public sector of ISK 0.8 billion.

Turning to tax policy, in December the Government decided to postpone its plans for a reduction in income taxes in 1986 and a lowering and streamlining of tariffs. Moreover, income taxes as a percentage of current income will be raised from 3.25 percent to 4 percent. At the same time, the planned levy of a special excise duty that was to compensate for the income tax and tariff reductions has been postponed. The net revenue loss of these measures was counterbalanced by further expenditure cuts and increases in user fees and certain excise levies.

In sum, the 1986 fiscal budget is characterized by three factors: foreign borrowing by the Treasury and other public entities will not exceed amortizations of foreign debt; according to the most recent treasury estimates, the revenue deficit will be lowered from about 2 percent of GDP in 1985 to approximate balance in 1986; treasury expenditure as a proportion of GDP will not grow in 1986.

Since 1984, the domestic capital market has been liberalized both through institutional and structural reforms and through direct liberalization of interest rate determination. With certain exceptions, the deposit money banks have been granted freedom to set their own interest rates. Later this year, following new legislation, commercial and savings banks will be fully empowered to determine their own interest rates. Following the full liberalization of interest rates, the Central Bank will influence interest rates only indirectly, among other things, by trading on the Securities Exchange, which is about to commence operations.

The Central Bank has ceased rediscounting produce bills since the transferral of financing of export stocks to the commercial banks and the concomitant lowering of reserve requirements. This makes the conduct of monetary policy more efficient, given the automatic nature of the rediscounts. It should be stressed that the reserve requirements were lowered solely to facilitate the transfer of produce financing to the commercial banks. This is one of the most significant of the recent monetary reforms and, in the view of my authorities, it is not expansionary.

There are strong indications that the substantial increase in real interest rates in Iceland during the last two years is leading to a better balance in the credit market. However, the full impact of the rise in real interest rates and the institutional and structural changes in the monetary area will necessarily take some time to come through.

I would like to emphasize the importance that my authorities attach to the policy of further liberalization in the monetary area and continued movement toward market-oriented interest rate policy. Increased market determination of interest rates can be expected to rationalize the present structure of interest rates and to bring about improved monetary stability.

Preliminary figures for the last quarter of 1985 show that the credit expansion in this period decelerated markedly. The credit expansion of the deposit money banks on a 12-month basis had declined from 38 percent by the end of September to 28 percent by the end of the year.

My authorities intend to pursue the same exchange rate policy as in the recent past. It is expected that this year's real krōna exchange rate will, on average, be close to what it was in the latter half of 1985. Naturally, this policy may have to be revised if economic circumstances change in unforeseen ways.

According to the most recent forecast, real GDP will grow by 2 percent in 1986. The current account deficit is forecast to be reduced to 3.5-4 percent in relation to GDP. The 1986 fiscal budget assumes a 20 percent rise in prices over the course of the year and an annual average increase of about 29 percent. Given the prevailing uncertainty concerning the forthcoming general wage negotiations, price developments are difficult to predict. The Government will seek to contribute to a moderate labor market agreement through tight monetary and fiscal policies.

The forecasts on the real economy are based on various assumptions, of which those concerning fish catches are particularly important. The Government's measures for conservation of fish stocks, recently extended for the next two years, have been aided by favorable conditions in the waters around Iceland.

A 3 percent increase in exports is forecast for 1986. Imports are expected to increase by 1 percent. The outlook for the terms of trade is clouded by uncertainties regarding developments in major exchange rates during the course of 1986. The terms of trade tend to deteriorate with a decline in the U.S. dollar and this may put pressure on the exchange rate.

In my authorities' view, the debt simulations presented in Appendix I of SM/85/333 give an unduly bleak impression for the following reasons.

First, the export projections of the staff are too pessimistic. This is evidenced by the fact that present foreign demand for Icelandic exports is growing briskly and it clearly outstrips supply in most markets. The prospects for meeting this demand seem favorable as the marine environment around Iceland has improved. Marine biologists are cautiously optimistic about the outlook for the next few years. Second, the staff's assumption about the interest rates on the Icelandic foreign debt of 10 percent in 1986, declining gradually to 9 percent in 1990, does not square with the fact that the LIBOR dollar rate is at present about 8 percent. Third, the present and prospective debt maturities used by the staff are too short. The staff assumes an overall maturity of 7 years for all new foreign borrowing, while 10-15 years seem to be more realistic. All of this combines to overstate the current and future burden of foreign debt.

The Icelandic authorities follow a consistent policy of maintaining manageable repayments of external debt by undertaking only long-term borrowing and by prudently managing the debt portfolio. Iceland was among the first members to compile and publish regularly thorough statistics on external debt. Consequently, my authorities welcome evaluations of Iceland's foreign debt profile. It is evident, however, that the value of such exercises depends on the realism of the assumptions on which they are based.

The Icelandic authorities recognize the gravity of Iceland's debt position. It is obviously true that improvement of this situation requires that Iceland keep the growth of domestic demand well below export growth over the next few years. This is illustrated clearly in the Government's own medium-term projections reported in the 1986 National Budget.

In recent years, the ground for diversification of the economy has been laid. The country's huge energy potential has already made possible important steps toward diversification and further steps are under consideration. New industries are in the early stages of development, notably fish and fur farming. At the same time, the traditional fisheries and agricultural industries are in the process of adjustment, after having been burdened by structural rigidities for a long time. The staff points out the increase in the amount of agricultural export subsidies in 1985. This increase, however, was temporary, and reflects not a higher rate but only the timing of payments. The Government will reduce agricultural subsidies in 1986, and has decided to phase them out over the next three to five years.

The Government has initiated measures to promote innovation, research, and development both by restructuring the investment credit funds and by setting aside funds for financing technical innovation and product development. The Government has also taken the initiative to establish and finance, in cooperation with private industry, a new venture capital fund to provide risk capital for new ventures in all branches of industry, trade, and services.

The persistent current account deficit and the increasing burden of external debt are undoubtedly the most serious problems facing the Icelandic economy. My authorities consider that the most urgent economic policy tasks are to halt the accumulation of foreign debt and to create an environment that is conducive to higher, noninflationary growth. It is against this background that the Government's economic program presented in the 1986 National Budget establishes the aim of balancing the current account by 1988.

Mr. Pickering observed that the Icelandic economy continued to perform well in a number of areas. Most important, employment rates remained remarkably high and economic output had been growing steadily for the past several decades. Recessions, such as that experienced in 1982-83, had been short lived. Against that relatively favorable background, performance in respect of the balance of payments position and the inflation rate had been disquieting. The rise in external debt and the burden of debt servicing gave cause for concern about the outlook for the economy as a whole.

The staff report for the 1985 Article IV consultation concisely reviewed the adequacy of economic policy in the main areas of the economy, and he could broadly endorse the staff's conclusions and recommendations, Mr. Pickering stated. On the external front, the staff had given prominence to the high external debt in relation to GDP, noting that the size of the debt posed a threat to stable economic management.

There appeared to be legitimate reasons for the difference of view between the staff and the authorities on the medium-term outlook, Mr. Pickering commented. In that regard, the uncertainty implicit in any medium-term assumptions underscored the importance of bringing the current account into balance as soon as possible. The Board had seen many examples of countries that had regretted their complacent attitude toward the balance of payments deficit when the foreign financing on which they had long relied suddenly disappeared. He therefore welcomed the stated commitment of the authorities to balance the external current account by 1988.

The need for supporting demand management policies was clear, Mr. Pickering remarked. One had only to look at the deviations from the 1985 budget or the monetary acceleration in 1985--depicted in

Chart 5 of SM/85/333--to become uneasy about the trend in demand management policies, which had been characterized by two particularly regrettable features. First, the strong and bold efforts initiated in May 1983 to restore balance to economic policies had been severely eroded by the lack of policy complementarity. Second, during the previous Article IV consultation, the Icelandic authorities had recognized the dangers of slippages in 1984 and had undertaken to improve performance in 1985; their inability to consolidate a political position since that time was regrettable and had only served to make the required correction more substantial and the need for immediate action more important.

The expected tightening in fiscal policy in 1986 must be supported by tighter monetary policy, Mr. Pickering considered. The number of important institutional changes that had been introduced over the past few years aimed at improving financial intermediation were welcome, but it would be regrettable if those improvements served to mask an unintentional easing of monetary policy. In the circumstances, he was interested in the assessment by the staff and the authorities of the adequacy of interest rate policy. As he understood it, the authorities were reportedly satisfied with a real rate of interest in the range of 3-5 percent on indexed loans, although they were prepared to raise those rates further if warranted in 1986. Unfortunately, even though conditions had existed in 1985 for some tightening of interest rates, that tightening had not occurred; it was unclear what size of monetary slippage would be required in 1986 to prompt the authorities to raise interest rates further. Another area of uncertainty was related to the indication by Mr. Lundstrom that the impact of the substantial increase in real rates over the past two years would take some time to be felt. At the same time, the staff had noted that real interest rates on nonindexed loans had "tended to become negative again." While those statements were not inconsistent, they pointed to a difference of view between the staff and the authorities. The authorities should be firmer in their implementation of interest rate policy.

An important risk mentioned in the staff paper was the possibility of an acceleration in the wage-price spiral, Mr. Pickering observed. Constraining demand management policies would be useful in preventing such an acceleration, although the authorities should perhaps also focus on the system of the inflation indexation, which they had embraced for a number of years. In Appendix I of SM/85/339, the staff had pointed to some of the difficulties of that system of indexation. In fact, the preliminary success of the measures adopted in May 1983 had been based on the authorities' firm policy of ignoring indexation and, instead, correcting real wages. Perhaps the system of indexation in Iceland did not allow the country to respond efficiently to the important external shocks and policy-induced depreciations facing the economy; if so, greater emphasis should perhaps be given to complementary action in that area.

The authorities' desire not to use the real exchange rate as a tool of economic adjustment seemed appropriate, Mr. Pickering remarked, especially since the real exchange rate was already low by historical standards. However, further devaluations could be avoided only if complementary policies were supportive. On a minor point, it seemed that the staff's appendix on statistical issues pointed to several important deficiencies in the data concerning the Central Government and the public financial institutions. The intention of the authorities to broaden the definition of the treasury account was welcome; such action would lead not only to a better assessment of fiscal policy but also to some improvement in the provision of timely statistical data.

In conclusion, Mr. Pickering commended the Icelandic authorities for the successes they had achieved in the area of economic management. While there was no compelling short-term crisis requiring correction of the external balance, the authorities should use what room for maneuver they had to take action to improve the medium-term well-being of the economy. The indications were that the current imbalances were less subject to self-correction than in the past and that policies specifically aimed at closing the balance of payments gap were required. The implementation of such policies would involve the difficult but essential tightening of fiscal and monetary policies.

Mr. Steinberg observed that, in spite of the increase in the fish catch in 1985 to a level close to the peak achieved in 1981, the current account deficit in Iceland had remained at about 5 percent of GNP. The inflation rate, which had fallen sharply in 1984, had picked up again in 1985, albeit at rates below those that had been experienced in preceding years. Macroeconomic performance had not been as good in 1985, although the real earnings and consumption of individuals had risen, while unemployment had remained virtually nonexistent. The current situation could continue only for a short time, as the Icelandic authorities themselves had discovered in 1982 and 1983. Unfortunately, the courageous measures adopted in 1983 by the authorities had so markedly reduced both the rate of inflation and the current account deficit that they had been followed by a lax income policy coupled with expansionary monetary and fiscal policies. Such a stop-go approach was not conducive to consolidating successes and abating uncertainties.

The fact that the current account deficit had not declined in 1985, despite a rising fish catch and fish-related exports, had been due partly to the weak world aluminum market and partly to the continued increase in imports--particularly in consumer goods--by 9 percent and 7 percent in 1984 and 1985, respectively, Mr. Steinberg remarked. The continued growth of imports was related, according to the staff, to rising domestic demand and to the real appreciation of the krōna. When domestic demand rose, it could lead to either a higher balance of payments deficit or a higher inflation rate, or both. Holding the exchange rate stable would shift the pressure from the domestic to the external accounts. The Icelandic authorities had used the exchange rate as an important, and at times as the only, instrument to reduce inflationary pressures and influence wage negotiations with the labor unions. However, the experience with such a partial policy in Iceland, as well as in other countries, was not promising.

An artificial stability of the exchange rate, which might be beneficial in the short run, would eventually end with a wave of speculations and capital flight. It was difficult to detect capital flows in Iceland because the financial markets were less than active and because foreign exchange could leak through the current account.

Fiscal and monetary policies in many countries were the most important tools for achieving economic goals, Mr. Steinberg noted. In Iceland, however, those tools were apparently not being actively used to achieve macroeconomic targets. How else could one explain the fact that the loss in revenue owing to the reform in direct taxation--which was by itself questionable--was not being offset by higher indirect taxes at a time when a tighter policy was called for? How else could one interpret the fact that monetary developments seemed entirely in the hands of the commercial banks, with nominal interest rates falling in 1985 in the face of accelerating inflation, thus turning real interest rates negative again. It could reasonably be argued that expansionary monetary and fiscal policies were necessary to maintain full employment when the fish catch was low, but it was unclear why the authorities would pursue an expansionary policy in 1985 when the fishing industry was booming and the labor market was tight. Staff comment on that matter would be helpful.

He had read with interest the staff's analysis of the inflationary process in Iceland, including its causes and effects, and he tended to agree with the staff that the indexation of financial instruments could help, during a period of accelerating inflation, to protect savings and mitigate social and economic distortions, Mr. Steinberg said. However, he found the discussion rather weak on the role of indexation when inflation was relatively stable, as it had been from the early 1970s until 1982. On the transition toward lower inflation, the staff felt that indexation of financial instruments "may well have added to the task of disinflationary policies." Further on in its discussion, however, the staff had qualified its statement by concluding that, in the Icelandic context, "the issue of financial indexation is of secondary importance" and did not undermine the stabilization process. Even if he could accept those statements, it was important to know if, when, and how deindexation could be part of a comprehensive adjustment program. On a related matter, the rise in real wages between mid-1984 and mid-1985, despite the continuation of the two-year ban on wage indexation, reflected the union's ability to change contracts and to invoke provisions before the dates agreed upon. He wondered whether that meant that the relative strength of the social partners was more important than the indexation.

The authorities' outlook for the Icelandic economy in 1986 was seen by the staff as optimistic, Mr. Steinberg noted. Based on past performance, and in the absence of policy measures designed to achieve the authorities' goals, he found the staff's alarming forecast as more realistic. So far the authorities had been prompted to take corrective measures only when the economy faced a very high inflation rate. The question was whether the next inflationary cycle or, perhaps, the growing external debt burden would turn out to be the new signal for corrective action. The next adjustment cycle could come in the form of either preventive measures by the authorities or an external constraint applied by the international banks. He hoped the authorities would not wait for pressure from the banks but would take action themselves. In that regard, he was pleased to note that the Icelandic authorities intended to put the current account into balance by 1988, and he hoped soon to see the policy measures designed to achieve that goal.

Mr. Ebrill stated that his chair was in broad agreement with the staff appraisal of the economic situation in Iceland. The staff had noted that, while many aspects of economic performance had been satisfactory, the past few years had seen the resumption of a cost-price spiral and the re-emergence of the large external current account deficit. The authorities had adopted corrective measures but, as the staff had noted, further measures might be required.

On the conduct of economic policy in Iceland generally, Mr. Ebrill noted, first, that Iceland was a small, open economy that relied heavily on a single product for the bulk of its export revenues. At the same time, Iceland had historically employed extensive indexation arrangements, which could complicate the conduct of economic policy. If inflexibly applied, those arrangements could reduce the capacity of the economy to absorb external shocks. In 1983, for example, the economic situation in Iceland had deteriorated in part because of a decline in the fishing industry, a problem that had required, inter alia, a suspension in wage indexation so as to permit the necessary decline in real incomes. Unfortunately, such difficulties could surface again. Second, it was clear from the staff report that both monetary and fiscal policies had recently tended to be expansionary and had resulted in a widening of external deficits and the re-emergence of inflationary pressures. The deterioration in the external current account was of particular concern, given Iceland's relatively large external debt. He agreed with the staff that the resolution of the problem lay in a tightening of monetary and fiscal policies. In general, it was important not to place the entire burden of adjustment on the real exchange rate; reliance on such a tool would be tantamount to treating only the symptoms rather than the cause of the problem. The result could be short-term relief at the cost of an accelerating rate of inflation. In that respect, he was encouraged that the authorities did not anticipate major changes in the real exchange rate in the current year.

Some of the fiscal deficit in Iceland had been due to delays in introducing taxes to replace reductions in income taxes, Mr. Ebrill continued. As pointed out by Mr. Lundstrom, commendable steps had been taken to alleviate the problem; however, given the vulnerability of the budget to possible developments in the 1986 wage round, it seemed advisable for the authorities to adopt a flexible approach to fiscal policy so as to enable them to respond to the outcome of the wage negotiations. Such flexibility would be particularly important, since the shift in the tax base from direct to indirect taxes was likely to reduce the underlying elasticity of the tax system. Noting that, as originally envisaged, the value-added tax was to have been in place as of January 1, 1986, he would welcome staff comment on what progress had been made toward the goal of implementing that tax.

Beyond the short-run difficulties in the Icelandic economy were longer-term problems rooted in the productive structure, Mr. Ebrill said. In that respect, the authorities should be commended for their efforts to diversify the economy and to liberalize and deregulate the financial and capital markets. In conclusion, economic conditions in Iceland demanded the adaptation of economic policy to external circumstances. In particular, in view of the current account deficit and the external debt situation, the authorities needed to maintain or strengthen their conservative stance on monetary and fiscal policies.

Mr. Bengs observed that on the occasion of the previous Article IV consultation discussion on Iceland, the Executive Board had recommended a pronounced strengthening of financial policies, together with firm domestic demand management aimed at bringing about a sustained improvement in the external accounts. It was disappointing to note from the latest staff paper that the authorities had not followed those recommendations but had continued to pursue relaxed financial policies leading to a further aggravation of the imbalances in Iceland's economy. Indeed, data for 1985 suggested that Iceland's economy was about to overheat in the wake of continued demand pressures emanating from too expansionary fiscal and monetary policies as well as from generous wage settlements. Inflation had accelerated, and the external current account deficit had remained high, with fiscal policy in particular having increased the risk of further growth in the wage-price spiral especially in an environment of widespread indexation. Moreover the data presented in the supplementary paper confirmed those worrying trends. Iceland's total net external debt was projected to have exceeded 60 percent of GDP in 1985, a figure that was high by international standards, thus jeopardizing Iceland's creditworthiness.

Recent developments as well as the staff's projections indicated that a continuation of present policies was clearly unsustainable, Mr. Bengs remarked. The medium-term projection on the external position--including the external debt situation--made it clear that a further delay in the necessary correction of domestic policies would not only lead to an unsustainable external position but would increase the unavoidable adjustment costs to be borne at a later stage. Hence, he agreed with the staff that a quick reversal of current policies was badly needed. While the authorities had agreed in principle on the need to bring the external accounts into balance and on the need to pursue suitably restrained financial policies, they apparently held very different views from the staff on the assessment of recent developments and, thus, on the degree of necessary corrective action. That difference of view was particularly striking with respect to the projections for growth in domestic demand and in developments in the current account. He found also particularly striking the differences in assessing the stance of fiscal policy planned for 1986, with the authorities viewing their budget as a first step in a medium-term fiscal adjustment effort, whereas the staff was concerned that it did not constitute an adequate first step in the medium-term adjustment strategy.

On balance, the fiscal measures envisaged thus far for 1986 fell short of what was required, Mr. Bengs said. The fiscal stimulus was likely to be far too strong to bring about a measurable reduction in domestic demand pressures, and the public sector borrowing requirements were likely to remain high, once again placing a serious strain on the conduct of monetary policy. Hence, he joined the staff in encouraging the authorities to take additional fiscal measures. The authorities had taken some additional steps in December and, while it was encouraging to note that those steps included a postponement of the plans for a reduction of income tax in 1986 and to raise income taxes somewhat, he remained unclear about the net impact of the December policy decisions on the fiscal position in 1986.

He was also in broad agreement with the staff appraisal and recommendations regarding monetary policy, Mr. Bengs commented. The needed tightening of monetary policy would be difficult to achieve in the absence of complementary fiscal policies and a strict limitation on foreign borrowing by the banks and the Government. Nevertheless, the Central Bank could contribute to the needed tightening by pursuing a somewhat more adequate interest rate policy. Real interest rates on nonindexed loans and most deposit rates had tended to become negative and had thus failed to reduce excessive credit demand. While it was encouraging to note from Mr. Lundstrom's statement that credit expansion in the final quarter of 1985 had decelerated markedly, it remained to be seen whether that trend would continue.

It was clear from the paper that the authorities and the Fund staff also had different views on the adequacy of the present level of the exchange rate as well as on the appropriate direction of future policy, Mr. Bengs noted. While believing that the exchange rate should not be relied upon excessively--and particularly not exclusively--as an instrument for adjustment, he had some sympathy with the staff's argument that Iceland's external position had taken a turn for the worse in the wake of large current account deficits and some appreciation of the real exchange rate. On balance, the authorities could allow the exchange rate policy to play a lesser role in promoting adjustment only if they were able to tighten financial policies to the extent necessary. In any event, the staff's suggestion to review exchange rate policy at the latest following the next round of wage agreements appeared to be appropriate.

Mrs. Walker observed that in some respects, the Icelandic economy had improved dramatically in the past two years. Real GNP had recovered from a decline of 5.7 percent in 1983 to an expected rise of 2.5 percent in 1985; inflation had been cut from a peak increase of 130 percent in 1983 to only 15 percent in the third quarter of 1984; and unemployment had remained at about only 1 percent. The authorities should take credit for having implemented a policy package in May 1983 that had helped to revive growth and reduce inflation. Nevertheless, the steps taken during the past two years had not been accompanied by sufficiently tight fiscal and monetary policies, and progress on inflation had been impeded by the willingness to meet high wage demands. Inflation had accelerated to more than 30 percent; the current account deficit had increased to 5 percent of GNP; and the money supply (M3) had been increasing at an annual rate of 50 percent. Moreover, external debt, at 60 percent of GNP, was proportionally the second highest in the OECD, and debt servicing had amounted to 22 percent of exports of goods and nonfactor services. Those data underscored the need for more stringent fiscal and monetary policies in order to reverse the increase in the inflation rate and reach a balance of payments position that was sustainable in the context of a continued revival in economic growth.

She was in agreement with many of the policies highlighted by the staff for consideration by the authorities, Mrs. Walker continued. On the fiscal front, she welcomed the efforts of the Icelandic National Economic Institute to devise a set of central government and public sector accounts on a national income accounts basis, which should assist the authorities in better analyzing Iceland's fiscal policy and its impact on the overall economy. However, the staff apparently felt that the changes in accounting procedures were not yet sufficient to give a fully accurate picture of the fiscal accounts, and she hoped that further progress in that area could be made.

The 1985 budget had not resulted in the anticipated partial reversal of the deterioration in the fiscal position during the first part of the year and, according to the supplement to the staff report, the treasury deficit had been 2.2 percent of GDP in 1985, Mrs. Walker recalled. Furthermore, the gross borrowing requirement of the public sector was predicted to be 7.5 percent of GDP. While the achievement of an approximate balance in revenue as a percentage of GDP and the maintenance of treasury expenditure as a proportion of GDP in 1986 would both be helpful, she agreed with the staff that "the budget for 1986 does not constitute an adequate first step in the medium-term adjustment strategy." Indeed, what was needed in her view was a surplus in the central treasury accounts.

The Icelandic authorities had not, as she saw it, made adequate progress in the control of their money supply, which had increased far in excess of the rate of inflation in 1985, Mrs. Walker observed. Credit expansion remained high, despite a decrease in central bank advances and an increase in real interest rates. That credit expansion had contributed to demand pressures and to a loss in net foreign assets of the banking system. While recognizing the difficulties in controlling the money supply, with increased reliance by the Treasury and commercial banks on foreign borrowing as a source of funds, she agreed with the staff that limiting direct treasury borrowing from the Central Bank and from abroad was important. The recent institutional changes in monetary control that had opened the way for market forces to determine interest rates were welcome. Particularly helpful was the change in policy of rediscounting loans, a policy that in the past had encouraged excess borrowing by the commercial banks. However, the lowering of the reserve requirement from 28 percent to 18 percent offset some of the restraining effect of the new rediscounting policy in 1985. An increase in positive real interest rates on loans should help to stem excessive borrowing. While the replacement of central bank prescribed interest rates, an arrangement allowing commercial banks to propose interest rate changes, could be seen as an improvement, the arrangement nevertheless fell short of a truly market-oriented system. She agreed with the staff that the optimal functioning of the financial system remained hampered by selective policies that regulated the structure of interest rates. In that regard, the authorities' intention to deregulate interest rates on deposits in 1986 was welcome. Positive interest rates on deposits could help to raise the current low level of savings. She would be interested in any elaboration that might be provided by the staff or Mr. Lundstrom on the authorities' plans to deregulate interest rates on deposits in 1986.

Expansionary financial policies had contributed to tight labor market conditions and generous wage settlement in Iceland, Mrs. Walker noted. She agreed with the staff that, as the 1986 wage round was initiated, high inflationary expectations and strong domestic demand would probably lead to large wage demands, with potential for feeding the wage-price spiral.

Iceland's external debt burden continued to be a matter of concern, Mrs. Walker said. In the 1984 Article IV consultation discussion, her chair and others had considered the debt situation worrying and had viewed an improvement in the current account as necessary to help alleviate the growing debt burden. Expansionary financial policies had contributed to strong domestic demand and, thus, to import demand, giving rise to a current account deficit, even in the revised accounts, of about 5 percent of GNP. The accumulation of deficits had resulted in high and growing levels of debt to GNP and debt service ratios. The staff had appropriately pointed out the potential damage to Iceland's creditworthiness, the difficulties of reducing the debt in light of the dependence on exports of fish production, and the constraint that debt servicing was imposing on the economy. She welcomed the authorities' intention to balance the current account by 1988.

It was clear that a tightening of financial policies would be necessary before the present value of the exchange rate could be consistent with sustained adjustment, Mrs. Walker said. She was pleased that the authorities acknowledged the importance of a more restrictive credit policy for the viability of their exchange rate policy and that they intended to review the exchange rate following the next round of wage negotiations. In its paper on recent economic developments in Iceland, the staff had reported on the expected establishment of an Icelandic securities exchange by the end of 1985. Comment on the structure and functioning of the securities exchange--which could contribute to a more efficient capital market--would be welcome. The authorities should be commended for their efforts to liberalize and deregulate certain sectors of the economy, and she was in agreement with their decision to increase the role of market forces in previously sheltered sections of the economy. Diversification of production and exports would continue to be needed, particularly as limits were reached in the fishing industry. A scaling down of rates and a simplification of the tariff structure would also be welcome.

The staff representative from the European Department noted that the tendency for nonindexed interest rates to decline in 1985 was a matter of some concern. The staff felt that those rates should be increased as soon as possible, a move that would be helped by the realization of the authorities' intention to deregulate remaining deposit and lending rates later in the year. With regard to observed deficiencies in data availability, it was the staff's hope that the situation would be improved by a cooperative effort between the Fund and the authorities.

In response to Mr. Steinberg's question about why the authorities had not followed the policy intentions they had outlined in the previous year, the staff representative recalled, the authorities attached overriding importance, even in the short term, to the maintenance of a low level of unemployment, and the effort to achieve that goal through the pursuit of expansionary domestic policies had led to what might be considered an overtight labor market, with unemployment below 1 percent of the labor force. The real question was whether or not such a policy could sustain employment in the longer run, and on that issue the staff had its doubts.

Financial indexation in Iceland had served to maintain positive real rates of interest, at least in the important segments of the financial markets, the staff representative commented. Hence, it had served to prevent the flight of money in a period of rapidly accelerating inflation. However, financial indexation had also created some difficulties in maintaining monetary control, even though only half the money stock in Iceland was indexed. In the period of rapid disinflation following changes in incomes and exchange rate policies, monetary aggregates had slowed, albeit not sufficiently rapidly in the staff's judgment, and part of the problem might have been related to the indexation mechanism. Generally speaking, the staff felt that the authorities had maintained a relatively lax financial policy stance.

The introduction of the value-added tax had been postponed from the beginning of 1986 to the beginning of 1987, although no final decisions had been made in Parliament on that matter, the staff representative from the European Department noted. It was his understanding that among the fiscal measures adopted in December 1985 was a decision to postpone plans to reduce income taxes in 1986 and the agreement that the income tax system would be less than fully indexed. The estimated net effect of all the measures was to bring the treasury budget close to balance in 1986.

Mr. Lundstrom remarked that his Icelandic authorities shared many of the concerns expressed by Directors, including the concern that the stance of fiscal and monetary policies had not been sufficiently strong in recent years. Those policies had not proved sufficiently tight to support the forceful adjustment measures of May 1983, which had been successful in reducing the rate of inflation and curbing the then mounting current account deficit. However, the Icelandic authorities had taken or were preparing to take various measures to tighten the monetary and fiscal stance, one of the results of which would be a balanced fiscal budget for 1986. Another characteristic of that budget was the fact that foreign borrowing by the Treasury and other public entities would not exceed amortizations of foreign debt of those institutions. The retrenchment on the expenditure side was evidenced by the forecast that the increase in expenditures as a ratio of GDP would be brought to a halt.

Various measures for curbing future spending were currently under preparation, Mr. Lundstrom continued. The automaticity of certain expenditures was being reviewed, and a decision had been taken to eliminate agricultural export subsidies over the next few years. On the revenue side, the authorities intended to replace by 1987 the current sales tax with a value-added tax, although the introduction of that measure was complicated by the fact that various household necessities--for example, food--were exempted from the sales tax. Hence, in order to include food, separate measures would have to be taken to compensate low-income families for the sharp increase in the cost of their necessities. In that respect, the introduction of a value-added tax was a sensitive issue that involved careful political judgment.

He had indicated in his opening statement that the full impact of the rise in real interest rates and the institutional and structural changes in the monetary area would necessarily take some time to be felt, Mr. Lundstrom recalled. The substantial increase in real interest rates that had taken place in Iceland over the past 2 1/2 years had clearly had initial balancing effects on the credit market, but the long-term impact had yet to be seen. The same applied to the structural change that had been effected with respect to financing export stocks. Rediscounting produce bills by the Central Bank had had a direct expansionary impact on the monetary base. Since that change, the automatic expansionary link had been broken, at least where rediscounting of stocks for the domestic market was involved. To facilitate the transferral of the financing to the commercial banks, reserve requirements had been lowered. While the package had been designed not to be expansionary in 1985, it was obvious that some time would be needed to assess the impact of the lowering of reserve requirements and the concomitant strengthening of the foreign exchange position of the Central Bank. The implementation of the structural change, which the Fund had been recommending for some time, deserved commendation. Given that the main causes of monetary expansion had been the treasury deficit and strong foreign borrowing, the tightened stance in both those fields should help to contain monetary growth.

On the presentation of budget data, his authorities agreed with the staff that it was desirable to view the public sector more broadly than the traditional, narrow definition that the budget had allowed, Mr. Lundstrom stated. Beginning with the 1986 budget, a broader definition had been adopted. In the past, in the formulation of fiscal policy, attention had been paid to the public sector borrowing requirement in a broad sense, but that item would be reflected more adequately under the new bookkeeping approach. As to the conceptual definition of the budget deficit with respect to interest payments, it should be noted that the budget and the final treasury accounts used the method of inflation accounting under which the real portion of interest payments--and indexation or exchange rate effects on that portion--were recorded as current expenditure. The approach did not conceal any repayment commitments, as suggested in the staff paper, since those items were all duly recorded under financial transactions. That having been said, the point was well taken that there was a need for further clarification of the fiscal accounts and a need to show explicitly the entries that made it possible to define the budget balance in a manner that suited the requirements of analysis of the case at hand. Work toward that end was in progress.

Little could be said about labor market negotiations, the new round for which was about to begin, Mr. Lundstrom said. However, it was to be hoped that the tightened stance of monetary and fiscal policies for 1986 would create an environment conducive to moderate wage settlements. Inflation, which only a few years previously had been a priority matter in staff papers on Iceland, had taken a secondary position after having been brought down from an alarming rate in 1983. However, the authorities were not satisfied with the prevailing inflation rate and were aiming at further reductions. Iceland differed markedly from the OECD average on inflation and employment. The openness of the Icelandic economy made it more inflation prone than the economies of many other developed countries, and the heavy dependence on a single industry--the fisheries and fish processing industry--exacerbated Iceland's vulnerability to external shocks. Moreover, Iceland shared many of its neighbors' experiences with the difficulties of adjusting domestic demand in a sophisticated consumer society with a developed welfare system to changing external circumstances.

It was true that Iceland placed strong emphasis on full employment, Mr. Lundstrom commented. However, to state that full employment had been achieved solely through expansionary policies would be misleading. The labor force was not only well educated and efficient; it was also highly mobile, both in a geographical and interindustry sense. Moreover, real wages had proved to be flexible in Iceland, perhaps to a greater extent than in any of its neighboring countries, as most recently evidenced by the sharp fall in real wages following the statutory incomes policy measures of May 1983.

The Icelandic authorities welcomed close scrutiny and the evaluation of the debt profile, but they had strong reservations about some of the assumptions employed in the latest debt simulation exercise, Mr. Lundstrom noted. Those assumptions concerned the growth of exports, where his authorities felt the staff had been overpessimistic in its projections; international interest rates, which did not appear to square with either prevailing rates or the medium-term outlook; and the maturity structure. It was well known that the calculations of a debt simulation exercise were sensitive to even marginal changes in assumptions; hence, it was appropriate to provide information on how sensitive the projections were to each major assumption. Great care was needed, moreover, in the interpretation attached to such exercises. The models needed to be sophisticated enough to take account of the structure of the debt portfolio with regard to currency composition and the portions of the debt carrying fixed or variable interest rates. Simulation exercises necessarily involved a great deal of discretion, given the large financial interests at stake. Creditworthiness and borrowing terms could easily be impaired by alarming conclusions.

The protracted current account deficits and the increasing burden of external debt were the most challenging tasks facing his authorities, Mr. Lundstrom considered. They had committed themselves to pursuing policies that would correct the external imbalance over the next three years. Some of those policies were already in place; others would follow as it became necessary.

Responding to questions on the fiscal policy package, Mr. Lundstrom observed that cuts had been effected in both investment and current expenditures. More important, the postponement of the relevant tax measures should be seen in the context of the negotiations about to begin between the labor market parties. The significant increase in the cost of living index that would accompany the levy of the special excise duty could have exacerbated wage claims and made the negotiations even more protracted and difficult, a predicament the authorities wished to avoid.

The Icelandic authorities intended to apply incomes policy measures for a short period only, believing as they did that incomes policy could not be a substitute for sound monetary and fiscal policies necessary to shape the environment in which the contracting labor market parties made their decisions on income settlements, Mr. Lundstrom noted. Their approach was in line with the experience of many other developed countries where incomes policy had not been applied successfully, except for relatively short periods, and where they had ultimately been replaced by monetary and fiscal policies.

The Chairman made the following summing up:

> Executive Directors recalled that in 1983 the Icelandic authorities had taken bold and decisive measures to deal with the severe external and internal imbalances. In a short span of time, those measures had produced a dramatic improvement in, followed by a recovery of, economic activity. Directors noted, however, that subsequently a serious reversal had taken place owing to an unduly easy stance of financial policies. As a result, the economy is again characterized by strong demand pressures, a high and rising rate of inflation, and a large

external imbalance, which, if not corrected, could pose a threat to the maintenance of full employment--one of the prime objectives of Icelandic economic policy.

Directors observed that Iceland's net external debt was high by international comparison. The debt service burden is also heavy and mounting. Against this background, they urged the Icelandic authorities to give the highest priority to the objective of external adjustment and to adapt the present stance of economic policy accordingly. Specifically, Directors stressed that a significant tightening of financial policies and reduced reliance on external financing were needed in the face of strong domestic cost pressures caused by the overtight labor market.

Directors expressed concern about the role of fiscal policy in 1985 and 1986. They noted that treasury spending in 1985 had grown much faster than budgeted and also much faster than revenue. In view of Iceland's low tax to GDP ratio, it was also regrettable that the first stage of the income tax reform had not been fully financed by increases in indirect taxes as originally planned, Directors stated. The public sector borrowing requirement has remained much too high, and Directors stressed that the medium-term outlook for the public sector finances underlined the need for early and decisive fiscal action. They welcomed the tightening of fiscal policy proposed in the 1986 budget, but agreed with the staff that it was inadequate in view of the size of the adjustment at hand.

Directors also expressed concern that monetary policy had been seriously weakened by excessive central bank money creation associated with large foreign borrowing by the Government and the banking system. Moreover, there was in Iceland an unfortunate reluctance to accept the interest rate implications of the large public sector borrowing requirement. As a result, real interest rates on nonindexed instruments have become negative again. Directors urged the authorities to strengthen interest rate policy and to maintain positive interest rates in real terms. An early and decisive break with the policy of monetary accommodation is also called for in order to dampen inflationary expectations and the attendant cost and price spiral.

Directors noted that the real exchange rate had appreciated in the course of 1985. While financial policies of restraint should be the principal instrument to correct the imbalance in the economy, exchange rate policy should also be kept under close review, taking into account all the relevant factors.

An adequate competitive position would also be crucial in lessening the dependency of the economy on the fishing sector. Directors supported the policy of liberalization and deregulation carried out in recent years that over time should assist in promoting the supply performance and diversification of the economy. Directors also welcomed the relatively liberal trade policy in Iceland.

Directors recommended that the next Article IV consultation with Iceland be held on the standard 12-month cycle.

APPROVED: September 10, 1986

LEO VAN HOUTVEN
Secretary