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0404

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 93/85

2:30 p.m., June 16, 1993

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
	A. A. Al-Tuwaijri
	J. B. Wire, Temporary
	B. Szombati, Temporary
	J. A. Solheim
	S. Shimizu, Temporary
	T. P. Thomas, Temporary
	K.-T. Hetrakul
	K. Link
	J. C. Jaramillo
	B. M. Lvin, Temporary
G. Lanciotti	
	D. Desruelle, Temporary
	P. A. Merino, Temporary
A. Mirakhor	
	J. A. K. Munthali, Temporary
	J. Dorrington
	O. Havrylyshyn
	D. Saha, Temporary
	C. F. Pillath, Temporary
	Y. Y. Mohammed
	K. J. Langdon, Temporary
E. L. Waterman	
	Wei B.
	A. F. Jiménez de Lucio

L. Van Houtven, Secretary and Counsellor
C. P. Clarke, Assistant

Also Present

European II Department: A. Sundakov. Policy Development and Review Department: T. Leddy, Deputy Director; J. H. J. Morsink. Research Department: J. D. Ostry. Secretary's Department: A. Mountford. Southeast Asia and Pacific Department: K. Saito, Director; L. M. Koenig, Deputy Director; P. J. Winglee. Personal Assistant to the Managing Director: G. R. Saunders. Advisor to Executive Director: R. Meron. Assistants to Executive Directors: D. A. Barr, M. Dzervite, S. C. McDougall, S. K. Regmi, S. Rouai, S. Vori.

1. NEW ZEALAND - 1993 ARTICLE IV CONSULTATION

The Executive Directors continued from the previous meeting (EBM/93/84, 6/16/93) their consideration of the staff report for the 1993 Article IV consultation with New Zealand (SM/93/106, 5/13/93; and Sup. 1, 6/14/93). They also had before them a background paper on recent economic developments in New Zealand (SM/93/117, 6/2/93).

The staff representative from the Southeast Asia and Pacific Department said that there was no significant difference between the staff's views and those of the authorities on monetary policy. The limitations involved in following a simple fixed rule for the conduct of monetary policy, which did not allow for all possible contingencies, were clearly recognized. Indeed, within the context of New Zealand's policy targets agreement, there were certain explicit and implicit caveats that allowed for flexibility.

One of the key objectives of the consultation mission had been to improve the staff's understanding of the Reserve Bank's framework for setting monetary policy, and it was with that objective in mind that the staff had suggested certain hypothetical scenarios, the staff representative remarked. The differences between the staff and the authorities seemed to be more of nuance than of substance. In the near term, the staff saw more slack in the economy, which might provide more of a restraining influence on inflation than the Reserve Bank believed. In addition, the Reserve Bank had previously stuck very closely to its inflation rule in conducting policy primarily to build the credibility of the Bank following a period of high inflation. Consequently, the Reserve Bank had been very reluctant to use the flexibility within the operating framework except in very clearly defined circumstances, the most notable of which was when the policy targets agreement had been renegotiated in December 1990 in the wake of the adverse terms of trade shock stemming from the Middle East crisis.

The staff's view was that, with the credibility of the Reserve Bank relatively well established, there might be more latitude for employing the flexibility that existed within the current framework, particularly in the context of a major reduction in the fiscal deficit that led to a depreciation of the exchange rate, the staff representative stated. In theory, a tightening of fiscal policy might be expected to induce confidence effects that would initially boost the exchange rate. Once the rebalancing of portfolios reflecting those confidence effects had taken place, however, and with the downward pressure on domestic interest rates resulting from those flows and the reduction in domestic demand coming from the fiscal contraction, the exchange rate would begin to depreciate. Empirically, of course, it was much more difficult to analyze the effect of a fiscal tightening on the exchange rate, because at any given point in time there might be more than one factor influencing the exchange rate. With regard to Mr. Waterman's point that most recent improvements in the fiscal position had been accompanied by a firming of the New Zealand dollar, such a trend might reflect the fact that the Reserve Bank had taken some monetary policy action over the same period in the pursuit of its goal of price stability.

The direct effect on real interest rates of a shift in the policy mix toward looser monetary policy and tighter fiscal policy was difficult to predict, the staff representative said. New Zealand was a small economy with an open financial market. As such, its domestic interest rates, particularly long-term rates, were determined by world interest rates. Accordingly, the differential between real interest rates in New Zealand and real interest rates in the rest of the world tended to reflect differences in the relative riskiness of holding New Zealand assets and expectations regarding real rates of depreciation. It was possible that a shift in the policy mix might indirectly lower real interest rates in New Zealand by improving the overall prospects for the economy. With regard to Mr. Havrylyshyn's comments about the optimal mix of policies, it was important to recognize that fiscal policy had a broad range of objectives in New Zealand, one of which was price stability. The authorities viewed it as more appropriate and productive to give monetary policy the one objective that it was most suited to achieving, namely, price stability.

The protracted nature of the adjustment period, and particularly the sharp rise in unemployment, might reflect the sequencing of reforms, the staff representative suggested. In particular, comprehensive labor market reform had been the last major piece of reform to be put in place, becoming fully effective only in early 1991. Human capital development was one of the Government's top priorities; indeed, the need to improve labor skills was motivating the Government's educational reforms and its efforts to redirect spending from other areas toward education. The authorities viewed immigration as one means of avoiding bottlenecks that might emerge as a result of skill shortages in an expanding economy. There was, therefore, some anticipation that there would be a reflow of human capital to New Zealand.

Much of the recent strength of New Zealand's exports was attributable to nontraditional exports, particularly manufactured goods, which reflected the improvement in the competitiveness of New Zealand's producers, the staff representative said. As a result, New Zealand had been able to increase its exports largely by increasing market penetration in some of its key export markets, most notably Australia. Consequently, New Zealand's exports had grown relatively strongly despite a very unfavorable external environment. In the future, the growth of New Zealand's exports would probably be more dependent on the growth of export markets, as the staff did not anticipate further substantial increases in market penetration; in particular, the performance of manufactured goods exports was linked to the performance of the Australian economy. Traditional commodity exports had grown despite a decline in world commodity prices, although the recent pickup in timber prices was a favorable development for the outlook for exports. Much of the growth in the traditional export sector was the result of varying the product mix and moving up the scale in terms of value added. Although that approach would be continued, developments in world markets were likely to have a more important influence on the growth of New Zealand's traditional exports. Looking at the external position more generally, there was some concern about the behavior of imports. The forecast for imports in the scenarios of both the staff and the authorities was predicated on the assumption of somewhat different behavior with regard to consumers and businesses. In particular, if consumption demand rose more rapidly than was currently envisaged, the associated rise in imports might put pressure on the balance of payments. In the staff's view, that possibility was more of a risk at the present juncture than weakness on the export side.

With regard to the Appendix on selective government intervention, the staff's intention had been primarily to prepare a survey of the existing literature, rather than analyze comprehensively all of the potential factors that might explain the development of the dynamic Asian economies, the staff representative from the Southeast Asia and Pacific Department remarked. In the beginning of the study, the point was made that saving was likely to have been much more central to the development of the dynamic Asian economies than government intervention. New Zealand had been trying to move toward some of the conditions that had contributed to the favorable growth performance of the Asian economies; in particular, it had increased the flexibility of the labor market and had taken various measures to enhance incentives for both savings and investment. In light of the interest that had been shown in the study, the staff was considering giving it wider circulation, perhaps in the Working Paper series or the papers on policy analysis and assessment.

Ms. Langdon made the following statement:

We join with other speakers in commending the authorities for their commitment to pursue and implement sound economic policies aimed at promoting sustainable noninflationary growth over the medium term. We would encourage them to continue in their efforts and consolidate the substantial progress that they have achieved.

I found Mr. Waterman's statement most helpful in clarifying the role of the exchange rate in the conduct of monetary policy. From the description in the staff report, the conduct of monetary policy appears overly mechanical and more rigid than we understand to be the case. Perhaps this is the trade-off for trying to be transparent. The report gives the impression that movements of the nominal exchange rate outside of some "comfort zone" will be resisted by the authorities regardless of the cyclical position and the underlying fundamentals. While it is noted that the authorities will adjust the comfort zone from time to time, there appears to be a risk of some confusion, at least in interpretation, over the conduct of monetary policy within a flexible exchange rate regime with price stability as its objective, which warrants further elaboration.

While not agnostic over the level of the exchange rate, it is our understanding that the authorities may resist movements in the exchange rate in response to their judgment of its inflationary impact--taking into account the cyclical position and whether it threatens to compromise the overall stance of monetary conditions required to achieve their inflation objective--not just its movements within the zone per se. I hope that Mr. Waterman will correct me if I am wrong, but my guess is that the authorities would share this view.

In terms of the near-term policy prescription, a difference in view between the staff and the authorities appears to emanate in part from a divergence in views on the degree of excess capacity in the economy and its impact on the inflation outlook. Perhaps Mr. Waterman or the staff could elaborate on what gives rise to this difference.

Finally, like other speakers and the authorities, we found the Appendix on selective government intervention and economic growth with regard to the dynamic Asian economies quite informative and useful. The study in the Appendix is useful in that it goes some way to dispel what seems to have become fact to the casual observer who looks to the growth performance experienced in this region recently and draws the faulty conclusion that selective government intervention is positively correlated to significant rates of economic growth. The study clearly indicates that there are other factors at work that have led to the impressive growth achieved in this region. Like Mr. Abbott, we think that increasing the profile of this section of the report would be warranted.

Mr. Jiménez de Lucio made the following statement:

The experience of New Zealand over the past decade is particularly interesting and relevant for developing countries. As the staff report states, until 1984, successive Governments followed protectionist economic policies, which resulted in a highly regulated and distorted economy, as well as large imbalances in the fiscal and external accounts, low growth, and high inflation; a story that by now sounds familiar.

Beginning in 1984, New Zealand embarked on a major structural reform program and has now become an open, market-based economy, with favorable prospects for achieving sustained growth. New Zealand's authorities are to be commended for not only having stayed the course of reform in the face of adverse short-term results, but also having responded to these results by deepening structural reforms, particularly in the labor market. Structural reforms take time to bear fruit and call for perseverance and patience to achieve the desired results.

We agree with the thrust of the staff's appraisal and will thus limit our comments to two points. A key factor for judging the success of any structural reform program is the flexibility of the labor market. Most often this highly regulated and fairly rigid market contributes not only to higher unemployment but also to its persistence for longer periods than would otherwise be the case.

A common response to labor market rigidity in developing countries is the emergence of a large informal sector, where lower wages and flexible working conditions prevail. Although the informal sector is an effective option for coping with the lack of employment opportunities in the formal sector, it has a number of important disadvantages; for example, informal companies seldom pay taxes, and their workers have limited access to social security arrangements. While many industrial countries are also affected by labor market rigidity, their response to such a situation tends to differ, as larger outlays for social expenditures and fiscal imbalances are more easily accommodated.

Introducing changes in labor market legislation is always difficult. The status quo tends to favor those currently employed, who are usually represented by strong unions with substantial political leverage. Labor market reform is, not surprisingly, one of the last tasks to be undertaken in many adjustment programs. Moreover, the need to reform the labor market often becomes evident at a time when the Government is already bearing the political costs of earlier reforms. A lesson from the New Zealand experience is that adjustment programs should address labor market reform up front.

New Zealand's success in controlling and lowering inflation is attributed in part in the staff report to the Reserve Bank Act of 1989, which made price stability the sole objective of monetary policy. Perhaps as important in our view is the transparent nature of monetary policy and the personalized accountability for achieving its targets. Regardless of the specific objective assigned to monetary policy, public knowledge of the targets to be achieved and of the persons with specific responsibility for achieving them helps to ensure that monetary policy is carried out effectively. This situation is in stark contrast to the secrecy that surrounds monetary policy in most countries. In addition, the methodology for defining price stability provides for government participation in monetary policy without impinging on the central bank's independence. Given its very favorable results, New Zealand's approach to monetary policy, based on transparency and accountability with independence, deserves study.

Finally, two words of caution. First, low inflation is not an economic objective per se, nor is it a sufficient condition for attaining sustainable growth and, thereby, for generating productive employment opportunities. Excessive focus on inflation can lead to an overly tight fiscal policy, lower growth, and higher unemployment. Second, New Zealand's growth prospects, like those of other small and open economies, is particularly dependent on external developments. A successful conclusion to the Uruguay Round, including improved access conditions for agricultural products, as Mr. Waterman points out in his informative statement, would likely boost New Zealand's growth prospects more than anything else.

Mr. Solheim made the following statement:

Since 1984, New Zealand has been implementing far-reaching reforms of its economic system. Although the performance of the economy has been somewhat mixed, there was in fact no alternative to the reform approach, given previous years' dismal developments and the unsustainable economic trends. While setbacks and difficulties will always occur in the course of such a restructuring process, it is reassuring to note that New Zealand is now beginning to reap some of the expected benefits of its adjustment policies through the present recovery of the economy.

I am in broad agreement with the staff appraisal and most of the comments made by previous speakers. At this stage, I will therefore only comment on some of the main policy issues.

The authorities have, on the whole, addressed the fiscal policy problems in a forceful and comprehensive way. However, the very high public debt represents an unsustainable long-term situation, and renders it absolutely necessary to proceed with the gradual fiscal consolidation in the years ahead. Even though I may, somewhat reluctantly, agree with the staff that a faster pace of consolidation may not be warranted in light of the risk of aborting the recovery, strong efforts to reduce the budget deficit are needed in the coming years. It is essential that the future fiscal stance result in a declining debt in relation to GDP.

I concur with the staff that further cuts and efficiency measures should be contemplated for public expenditure. However, some measures to increase revenue should not be completely ruled out, for example, a broadening of the tax base. After all, public revenue as percentage of GDP remains relatively low, and significantly below that of most other industrial countries.

Nevertheless, I should like to commend the authorities for their impressive achievements in cutting and streamlining public expenditure. Even though the problems may have been more pressing in New Zealand, an increasing number of industrial countries are encountering similar challenges, and they may have something to learn from the experience of New Zealand.

I am also impressed by the number of structural reforms being implemented, and that it has proved possible to receive political support for these measures. The financial liberalization process in New Zealand was looked upon as an example in some of the Nordic countries prior to their moves in the same direction. As the financial reforms are hardly touched on in this report, I assume that this sector has not encountered the same problems as in the Nordic countries. With regard to labor market reforms, New Zealand may also serve as a model for other countries in this area. Significant results appear to have been obtained in restructuring labor arrangements. Progress has also been accomplished in the trade area, but the pace of tariff reductions has nevertheless been relatively slow. I also share the staff's doubts about possible lessons from the dynamic Asian economies on selective government intervention to create a more competitive industrial sector. This is also the lesson from the Nordic countries, where we have very mixed experiences with interventions aimed at correcting so-called market imperfections.

Finally, I would like to make some comments on the monetary and exchange rate policy approach of the authorities, which is strongly geared toward price stability. Although price stability is a relatively common target for central bank policy, it is somewhat special to New Zealand that concrete inflation targets are agreed upon between the Governor of the Reserve Bank and the Minister of Finance. While I see clear merits in choosing inflation as a target for monetary policy, I feel more uncertain about the so-called exchange rate comfort zone as a primary indicator of inflation performance. In view of the complex and unstable transmission mechanisms for inflation, I find it somewhat surprising that so much emphasis is placed on the assumed effects of currency value changes on prices. Moreover, the central bank does not intervene directly in the exchange market, and exchange rate movements are influenced only through interest rate changes. Even though I understand from Mr. Waterman's statement and the responses of the staff representative that the conduct of monetary policy is more flexible than indicated in the staff report, the staff may have some comments on the extent to which the central bank's approach may result in very marked fluctuations in interest rates and/or exchange rates, and thus has adverse effects on investments and trade flows.

Mrs. Szombati made the following statement:

I would like to commend the New Zealand authorities for their broad-based, sustained structural reform efforts over the past several years to move their economy out of its lethargy, characterized by rising unemployment, weakening external competitiveness, and growing external debt. After a few years of slow response to liberalization and deregulation, the economy is now reaping the fruits of these adjustment efforts: growth is recovering, inflation is giving way to virtual price stability, and exports are growing vigorously, with a strong boost from improved cost competitiveness.

Nevertheless, sustained growth is not yet guaranteed by these accomplishments, which are still accompanied by large fiscal imbalances, a sizable public debt, and high unemployment. New Zealand faces the challenge of maintaining its good recovery pace while continuing to seek macroeconomic stabilization through more balanced financial policies. The recovery will have to depend largely on export growth, both because this is the most direct way of reducing external indebtedness and because such a small economy can only grow if it maintains its openness and builds strong two-way relations with the world economy. New Zealand's external competitiveness and efficiency are to be enhanced by continuing the drive toward structural reforms, especially with regard to further improving the labor market, eliminating monopolies, and liberalizing the external trade system.

I broadly agree with the staff's analysis of policy, and I have two additional detailed comments, the first on fiscal policy and the second on structural policies.

New Zealand must adopt financial policies aimed at limiting domestic demand to ensure that resources flow to the external sector, which must be the main motor of its economic recovery. We agree with the staff that the bulk of the adjustment burden should fall on fiscal policy, as the sizable fiscal deficit produced by several years of policy slippages remains an imbalance in macroeconomic terms. The Government's present loss of interest in fiscal consolidation is, therefore, rather disappointing, even though the deficit's mild downward trend has succeeded so far in maintaining the confidence of foreign investors. It is understandable that the Government feels concerned about the risk that a faster and more vigorous fiscal adjustment could slow the economic recovery, but, as the staff clearly points out, a continued mismatch between fiscal and monetary policies poses similar risks for growth if balance of payments pressures emerge.

The present external environment is less than favorable, and the risk is real that balance of payments problems could emerge from the slowdown in world economic activity and the increasing trend toward protectionism. It is our view that New Zealand's current high level of fiscal debt leaves little room for tolerating large fiscal imbalances, and that the Government should increase budget savings and protect its revenues by setting fixed objectives and a timetable for its fiscal consolidation measures. We wish to stress the importance of achieving a more balanced budget in a relatively short time, and we urge the authorities to take the steps needed to put the deficit on a downward path. The news that the 1992/93 deficit projection has been lowered is thus most welcome.

In the area of structural reforms, we can only commend the authorities for the dramatic progress they have made since 1990 by focusing their reform efforts on long-term productivity growth and competitiveness. We are particularly pleased that the acceleration of labor market reform has contributed to major improvements in total factor productivity by shifting to enterprise-based bargaining and greater flexibility in labor arrangements. To address the issue of productivity and competitiveness at the root, New Zealand should improve its efforts to improve labor skills and adaptability, and we are pleased that the Government's recent educational reforms aim not only to raise academic standards but also to make institutions more cost effective and more responsive to the needs of the economy. We urge the authorities to ensure full implementation of the planned reforms in this area and to extend the reforms pioneered in the labor market to all sectors of the economy.

Deregulation of agricultural product marketing and the further liberalization of foreign trade are the other two forms of structural reforms with the greatest potential in terms of enhancing New Zealand's efficiency and competitiveness. We agree with the staff that there is a need to eliminate or at least greatly reduce the monopoly power of the agricultural marketing boards. We welcome the authorities' intention to reassess the role of these boards in order to increase their autonomy and improve their performance. More efficient agricultural product marketing could greatly increase the already major share of agricultural exports in New Zealand's trade. In the area of foreign trade, we welcome the recent large strides toward the removal of import licensing and quotas, but we are concerned about the slow and uneven progress toward reducing protective tariffs. Accelerating the dismantling of all forms of de facto protection would increase the efficiency of resource allocation and encourage a reorientation toward productivity growth.

Mr. Lvin made the following statement:

The past decade would be probably considered the decisive one in the modern economic history of New Zealand. This decade started with the failure of the overwhelming state involvement in the economy, which led to destructive inflation and the distorted structure of the economy.

Bringing inflation under strong control and price stabilization were the most important targets of the authorities' economic policy in the beginning of the reforms. These targets were achieved and maintained. New Zealand now demonstrates both the costs and benefits of a consistent anti-inflationary policy. Its experience seems to be of great importance to the countries in transition.

The inflation rate has decreased to one-digit levels, and in the past year was as low as less than 2 percent. State control over entrepreneurial and labor activities steadily declined. Foreign trade and the financial sector were deregulated significantly. But the costs of these adjustments were a long period of decline of GDP and a rise in unemployment.

In general, the authorities' economic policy should be regarded as consistent and successful. The economy is on pace for recovery. In the last quarter of 1992/93, increases in GDP and the volume of retail sales were registered. At the same time, it is important not to allow the growth of demand to affect seriously the balance of payments and monetary stability. Downward pressure on the currency has already taken place in the past year. The authorities should keep in mind this risk.

It seems that the coming years will be crucial. Now, after the period of adjustment has lasted longer than anticipated and the signs of economic recovery are quite visible, there is very likely to be a temptation to speed up economic growth and loosen wage and fiscal policies. This temptation is especially dangerous on the eve of parliamentary elections.

In this regard, I would strongly support the staff's view about the comparative advantages and disadvantages of so-called selective government intervention. The experience with state intervention policies in the East Asian economies is rather controversial, and this intervention is by no means the major source of their rapid growth. Exceptionally deep reforms having been implemented, much more remains to be done. The central government budget is still in deficit. Government debt, denominated in both national and foreign currencies, has risen again after decreasing between 1986/87 and 1988/89. According to the Government, all proceeds from privatization sales have been used for the retirement of government debt and not to finance current expenditures. We urge the authorities to proceed further with privatization and to find both political and legislative solutions to remove barriers in this regard.

As regards regular budget revenues and expenditures, the authorities are focusing on the latter rather than on the former. They are committed to cutting expenditures rather than raising taxes. We commend this approach aimed at giving more room to private consumption and savings.

The decrease in, and the improvement in the structure of, budget expenditures is a great challenge to the authorities, because the bulk of these expenditures is social spending. The new liberal labor legislation, effective in 1991, brought new opportunities for rationalizing the employment structure. As a result, the scale of the nationwide wage-bargaining process and the extent of state control over this process were dramatically diminished, though not eliminated. The authorities' attempts to restructure social welfare programs, tighten unemployment benefits criteria, and decrease the so-called replacement rate have been quite successful and are rather commendable. We would encourage the authorities to review all the remaining social expenditures in order to make the labor market more flexible and public finances more stable and reliable.

The New Zealand economy strongly depends on the export of agricultural and forest products, and, therefore, the country is very interested in the establishment of a worldwide free trade regime. But its own tariff protection of domestic industry remains high. As New Zealand's terms of trade have significantly improved since the mid-1980s, with a slight worsening in the past three years, and the trade balance has been continuously positive, the further removal of import barriers would improve domestic consumption and the performance of export-oriented industries.

Finally, we would note the sharp rise of the private sector external debt from 26 percent of GDP at the end of 1988/89 to more than 50 percent of GDP at the end of 1992/93. Although the staff explains this phenomenon as strongly associated with valuation changes, we would express our concern about the willingness of the authorities to refuse to assume responsibility for this debt in the event of arrears or the insolvency of debtors, and thus to intervene in the economy and worsen the budget position.

Mr. Wei made the following statement:

New Zealand's economic performance has improved over the past two years as economic growth recovered, inflation declined, and the current account position strengthened. As Mr. Waterman points out in his informative and helpful statement, gains in competitiveness, reform over the past decade, and the conduct of proper macroeconomic policies were the critical factors contributing to such an improvement.

The task that lies ahead is well spelled out by the authorities' central policy goal, namely, to achieve sustained growth while keeping inflation low. Prospects for the economy in the medium term look favorable, with both exports and domestic demand expected to gain strength and fiscal and monetary policies geared to deficit consolidation and keeping inflation within the target range, respectively. Nonetheless, the course leading to the realization of the central policy goal is not without constraints, and efforts are needed to minimize possible complications.

Although already mentioned by previous speakers, I wish to stress again the importance of keeping the budget deficit on a downward path. We welcome the fact that the authorities are fully aware of this need and are committed to a balanced budget over the medium term. We are of the view that much of the consolidation effort required should fall on the expenditure side, especially in the low priority areas, with a view to preserving the momentum of recovery at this time. Meanwhile, we welcome the importance attached by the authorities to maintaining the revenue base and to using any unanticipated revenue gains for deficit reduction. From a medium-term point of view, it is also important that reform programs in the areas of health and education be firmly carried out.

In terms of monetary policy, besides maintaining an appropriate balance between the stance of fiscal and monetary policies, it is encouraging that monetary policy is essentially set with a view to keeping inflation within the 0-2 percent target range and that the monetary policy response to market developments will ultimately be based on their implications for meeting the inflation target.

On structural issues, the efforts to reform the marketing boards for agricultural products are particularly welcome, as they will go a long way toward improving the prospects of the agricultural sector. We also commend the authorities for moving quickly in liberalizing the trade regime, and we encourage them to further their efforts in reducing the level of protection that some sectors still enjoy.

Mr. Mirakhor made the following statement:

I join other Directors in commending the New Zealand authorities for their considerable achievements since the previous Board discussion on New Zealand. Both the staff report as well as Mr. Waterman's helpful statement provide the basis for confidence that sustainable growth and price stability in New Zealand are within reach. As stated by Mr. Waterman, New Zealand's experience shows not only that "sound macroeconomic policies and structural reforms will deliver positive results" but also that structural reform is a continuous and complex process, whose positive results take time to materialize.

This latter point is confirmed, in the case of New Zealand, by the unfinished agenda of financial consolidation aimed at further reduction of the budget deficit and the high level of public debt. In addition, further efforts in the area of structural reforms are still needed in order to strengthen the functioning of the labor market, reduce unemployment, and improve the overall efficiency of the economy. As I am in broad agreement with the thrust of the staff appraisal, I will limit my intervention to a comment and a question.

My comment relates to the interesting Appendix on the experience of high-growth Asian countries. A look at Chart 1 of the staff report showing the comparison of New Zealand's experience with that of the OECD countries on the basis of a number of economic variables indicates that the staff is quite right in suggesting that the experience of the Asian high performers may indeed be relevant to New Zealand's policymakers.

My question relates to the very interesting and, to my knowledge, original idea on page 12 of the staff report that "expenditure creep is being contained by holding department chiefs accountable for keeping outlays within three-year baseline projections and by enforcement of strict guidelines for supplemental funding." I am curious about the operational modalities and procedures for enforcing this imaginative approach to expenditure containment.

The staff representative from the Southeast Asia and Pacific Department said that the key difficulty at the present juncture was in trying to understand better the degree of slack in the economy, particularly after ten years of structural reform. Under normal circumstances, there would be a wide range of estimates of the slack in an economy at any given point in time. In the context of New Zealand, deriving such estimates was further complicated by the extent of structural change in the economy. For example, while structural reform could be expected to make obsolete a portion of the capital stock, labor reforms had increased firms' flexibility in scheduling labor, essentially doubling or tripling the effective capital stock. The chief concern in New Zealand, however, was that skill shortages might represent the more significant bottleneck; as he had mentioned previously, to some extent those bottlenecks might be relieved by immigration. With regard to labor market reform, it should be noted that the political situation also had to be factored into the sequencing of structural reforms. In the case of New Zealand, the reform process had been started by a Labor Government, whose initial approach to labor market reform had been more evolutionary than that of the current Government.

The impact on monetary conditions of focusing on the exchange rate as the key indicator for conducting monetary policy was largely a function of the authorities' emphasis on reducing inflation, the staff representative remarked. In the near term, the main indicator for inflation was the exchange rate, which was the key variable guiding the Reserve Bank in its efforts to achieve a target for measured, as opposed to some concept of underlying, inflation. In that context, there was some risk of potentially marked fluctuations in monetary conditions.

With respect to Mr. Lvin's comments regarding the external debt of the private sector, it should be recognized that part of the increase in that debt reflected certain special transactions, the staff representative from the Southeast Asia and Pacific Department noted. The sale of government assets, most notably the telecommunications company, had contributed to the increase in the external debt of the private sector owing to the way in which the transactions had been structured. The foreign participants in the consortium that had purchased the telecommunications company had financed their participation through debt, rather than equity, for tax considerations in their home market. Consequently, part of the rise in private sector debt might be considered somewhat artificial and, therefore, less worrisome. Nevertheless, the Government did not take the view that private external debt was the concern of only the private sector; rather, it took a more general view that New Zealand's overall debt position had an influence on economic conditions and belonged, therefore, in the province of macroeconomic policies.

Mr. Waterman remarked that at the end of the day, nations were basically interested in real income levels, employment, stability, and so on. Clearly, of course, policy settings were very important in influencing the performance of economies. As several speakers had noted, particularly Mr. Havrylyshyn, in one sense New Zealand could be regarded as a textbook example of the type of policies that a country should adopt; it should also be recognized, however, that 10-15 years previously New Zealand had been a good example of the type of policies that should not be adopted. Since then, there had been a number of reforms on a wide front--including product and labor market reform, financial sector reform, and a very explicit inflation objective--and recognition that the public and external debt situation was not sustainable. In the area of trade policy, he would disagree with Mr. Dorrington's comment that New Zealand's focus on reducing protection had been confined to the agricultural sector. Indeed, the imposing wall that New Zealand had erected against manufactured imports a decade previously had largely been dismantled, with very few exceptions, and it had moved to reduce tariff protection gradually, a process that would continue during the 1990s irrespective of the outcome of the Uruguay Round.

It was certainly true that the benefits from the reform process had been very slow in coming, Mr. Waterman considered, but the results did seem to be emerging. Indeed, growth of between 2 1/2 percent and 2 3/4 percent, an inflation rate of close to zero, and a current account deficit of 2 1/2 percent of GDP was not a bad outcome, especially when compared with the current performance of the world economy. It was, of course, very important that New Zealand stayed the course, and the support of the Fund was very important and welcome in that regard. As had been noted, there would be an election in New Zealand in 1993; while there did not seem to have been any signs of wavering on the part of either political party, the Fund's endorsement of the sort of policies that New Zealand had been pursuing was certainly very important for the ongoing policy debate within the country.

The authorities were very conscious of the need to further reduce the fiscal deficit and the level of debt as the 1990s proceeded, Mr. Waterman stated. Like many other countries, New Zealand had been adversely affected by the world recession. It was also being affected on the fiscal policy side, like some other countries, including Australia, by the pursuit of low inflation. Low inflation was useful in imposing discipline on governments, but it also tended to dampen the natural growth of revenue. As the staff had noted, it appeared that the outcome for the current financial year would be better than expected when the budget had been prepared, and some of those benefits would carry on into subsequent years. The authorities also recognized that there was a need to keep expenditure on very tight rein and to look for improvements in public administration. There would be a continuing focus on further savings in the areas of social security, health, and education. Some speakers had also commented that there was a need for higher investment in human capital with a view to getting more people into the work force. In sum, the authorities understood well that the battle on the fiscal side was never over.

Most of the projections suggested that the current account deficit would gradually decline toward balance, possibly even recording a surplus, which was quite remarkable, compared with the 1983/84 current account deficit of about 8 percent of GDP, Mr. Waterman said. If that result were accompanied by renewed confidence in New Zealand's economy and increased equity investment, it was likely that the level of external debt relative to GDP would first be stabilized and then reduced.

There had been a fair amount of discussion about monetary policy and the exchange rate and the relationship of both to fiscal policy, Mr. Waterman observed. In reviewing that discussion, it was important to remember that only a few years previously New Zealand had had one of the highest rates of inflation in the industrial world and that the very specific anti-inflation objective had been established in 1990. Inflation was currently in the desired range, which was a very significant achievement. The authorities recognized how easy it was for performance to deteriorate and the consequent need to be vigilant. As the staff and other speakers had noted, the exchange rate was a key variable for determining monetary policy, but it was not the only variable. There certainly was a comfort range that the authorities considered in deciding whether or not policy settings were appropriate, but they were also considering developments in wages, profits, and other factors. The basic framework was flexible, although it was inflexible with respect to the basic anti-inflation objective, and there was not likely to be any change in that aspect in the immediate future.

With respect to the sequencing of structural reforms, the reform process should, in theory, begin with labor market reform, moving on to product market reform and then financial market reform, Mr. Waterman remarked. In some sense, New Zealand and some other countries--including Australia--had reversed that sequence, which had created certain problems. It had to be recognized, however, that the reality of structural reform was that progress had to be made whenever and wherever it was possible. In both New Zealand and Australia, financial market reform had been a source of considerable discipline on economic policymaking and, in a sense, had led to subsequent reforms in other areas that might not otherwise have taken place.

A number of Directors had commented on the likely impact on interest rates and the exchange rate of further progress in reducing the fiscal deficit, Mr. Waterman recalled. In his view, the differences between the staff and the authorities on that issue were more of nuance than of substance. It seemed very unlikely to him that New Zealand's very small current account deficit, very low rate of inflation, reasonable growth, and balanced factor shares would lead to significant downward pressure on the exchange rate; indeed, the opposite conclusion seemed more likely.

The Chairman made the following summing up:

> Executive Directors were in broad agreement with the thrust of the appraisal in the staff report for the 1993 Article IV consultation with New Zealand. They noted the significant progress made in improving the structure of the economy, bringing down inflation, and enhancing competitiveness. It was particularly encouraging that the wide-ranging reform efforts initiated in the mid-1980s had begun to bear fruit, with the economic recovery now well under way. Directors recognized the importance of safeguarding the economic recovery, while stressing that this should be done in a manner consistent with the medium-term objective of achieving a high rate of economic growth with a sustainable external position in the context of continuing price stability.
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> The stance of fiscal policy in 1992/93 was seen as broadly appropriate. Directors welcomed the news that the outturn for the financial deficit in 1992/93 would be significantly better than earlier expected. At the same time, they stressed the desirability of pushing steadily toward fiscal consolidation over the medium term. Some Directors supported the staff's view that steps to eliminate the budget deficit within a shorter time frame than currently envisaged would be desirable in view of the country's high level of external debt and its servicing costs. In this context, Directors were generally of the view that, while efforts to preserve the revenue base would be needed, further measures to eliminate the budget deficit should focus predominantly on the spending side. In particular, major savings would have to be achieved in the areas of social spending. Although this represented a difficult task, Directors noted that continued attention to selective targeting of benefits and, in some cases, a focus on the level of assistance could generate significant budgetary savings and contribute to improving economic efficiency.

Directors commended the authorities for the achievement of price stability, noting the important role played by monetary and exchange rate policies. In view of New Zealand's previous inflationary experience, the stronger and more transparent framework for conducting monetary policy, and the increased degree of central bank independence, had helped to reinforce the credibility of the Reserve Bank.

Directors noted that the substantial efforts made to reform the economy had contributed to strengthening New Zealand's recent economic performance and prospects. They indicated that additional efforts would be required to ensure that the reforms already announced were fully implemented and that further reforms were pursued in a few areas. Labor reform has contributed to faster productivity growth and will continue to do so as it is applied on a wider basis. At the same time, labor and other economic reforms have placed a greater premium on the skill level of the labor force, and it was welcome, therefore, that the Government has responded by making the education system and job training programs more relevant and effective. Directors also acknowledged the useful role in improving economic efficiency, as well as in supporting the public finances and reducing debt, to be played by the Government's further initiatives to privatize public corporations. Some Directors added that economic efficiency could be enhanced by liberalizing the operations of the marketing boards for major export products.

Directors commended New Zealand's unilateral moves to liberalize the trade regime. They encouraged the authorities to continue with these efforts in the context of the tariff review scheduled for next year, especially with a view to more quickly reducing the high effective rates of protection that some sectors continued to receive. It was also observed that benefits could be expected to flow from a successful conclusion to the Uruguay Round that included reforms in agricultural trade.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/93/84 (6/16/93) and EBM/93/85 (6/16/93).

2. STAFF COMPENSATION ISSUES - TAX EQUIVALENCY ALLOWANCE - SIMPLIFICATION OF PROCEDURES FOR PAYMENT

The Executive Board approves the recommendations with respect to the simplification of procedures for payment of tax equivalency allowances for spouses and dependent children and the eligibility criteria for tax equivalency allowances and other benefits for which children are eligible, as set forth in EBAP/93/38 (6/11/93).

Adopted June 16, 1993

3. EXECUTIVE BOARD TRAVEL

Travel by an Assistant to Executive Director as set forth in EBAM/93/112 (6/11/93) is approved.

APPROVED: November 24, 1993

LEO VAN HOUTVEN
Secretary