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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 95/25

10:00 a.m., March 17, 1995

Contents

Executive Board Attendance

M. Camdessus, Chairman
S. Fischer, Acting Chairman
P. R. Narvekar, Deputy Managing Director

Executive Directors	Alternate Executive Directors
M. Al-Jasser	A. A. Al-Tuwaijri
M.-A. Autheman	M. Sirat
J. Bergo	E. Srejber
L. E. Berrizbeitia	V. J. Fernández
I. Clark	G. F. Murphy
B. S. Dlamini	
	J. Shields
K. P. Geethakrishnan	R. Kannan, Temporary
J. E. Ismael	L. M. Cheong
D. Kaeser	R. Cippa, Temporary
A. Kafka	A. Calderón
	J. Jonáš, Temporary
	D. Daco, Temporary
Y.-M. T. Koissy	H. A. Barro Chambrier
G. Lanciotti	N. Coumbis
K. Lissakers	
H. Mesaki	T. Fukuyama
	M. Daïri
	A. Rouai, Temporary
C. Saito	J. Justiniano, Temporary
S. Schoenberg	
A. S. Shaalan	Y. Y. Mohammed
	A. V. Mozhin
E. L. Waterman	J.-H. Kang
J. de Beaufort Wijnholds	
	Wei B.

L. Van Houtven, Secretary and Counsellor
S. W. Tenney, Assistant
S. Bhatia, Assistant

Also Present

African Department: E. A. Calamitsis, Director. Central Asia Department: A. Singh, Deputy Director; B. Chadha, G. M. Meredith. European I Department: M. Russo, Director; M. C. Deppler, Deputy Director; C. Christofides, D. G. Demekas, M. J. Fetherston, T. D. Lane, A. Leipold, F. Scacciavillani, S. Shirai. European II Department: J. Berengaut. External Relations Department: M. R. Kelly, Deputy Director; H. P. Puentes. Fiscal Affairs Department: T. M. Ter-Minassian, Deputy Director; D. G. Fanizza. Middle Eastern Department: K. Nashashibi, S. M. Nsouli. Monetary and Exchange Affairs Department: M. Guitián, Director. Policy Development and Review Department: J. T. Boorman, Director; M. Allen, Deputy Director; T. Leddy, Deputy Director; O. J. Evans, S. M. Schadler. Research Department: M. Mussa, Director; M. S. Khan, Deputy Director; F. Caramazza, R. A. Feldman, F. Larsen, P. R. Masson, M. A. Pradhan, R. Wescott. Secretary's Department: W. S. Tseng. Southeast Asia and Pacific Department: K. A. Al-Eyd. Statistics Department: J. B. McLenaghan, Director. Western Hemisphere Department: C. M. Loser, Director; J. R. Márquez-Ruarte. Office of the Managing Director: G. R. Saunders, Personal Assistant; M. A. El-Erian. Advisors to Executive Directors: J. M. Abbott, J. O. Aderibigbe, M. C. B. Arraes, P. Cailleteau, A. Chang Fong, S. S. Farid, S. K. Fayyad, T. K. Gaspard, A. R. Ismael, J. Leiva, Y. Margoninsky, S. O'Connor, C. F. Pillath, K. Sundara, Assistants to Executive Directors: S. Al-Huseini, P. I. Botoucharov, A. G. Cathcart, M. Dzervite, G. El-Masry, R. Ferrillo, H. Golriz, O. Himani, P. Jilek, A. M. Koulizade, K. Kpetigo, V. Kural, N. Laframboise, J. A. K. Munthali, Ng C. S., H. Petana, G. P. Ramdas, F. A. Schilthuis, G. Schlitzer, A. Sighvatsson, R. von Kleist, J. B. Wire, E. Zamalloa.

1. REPORT BY FIRST DEPUTY MANAGING DIRECTOR

The First Deputy Managing Director said that he had recently traveled to New York to attend the first meeting of the Middle East Economic Strategy Group. The Group, which was chaired by Paul Volcker and held under the auspices of the Council on Foreign Relations, comprised 14 eminent economists representing a broad geographical distribution of those interested in Middle Eastern issues. The Middle East Economic Strategy Group had been appointed at the First Middle East-North Africa Summit in Casablanca to report at the Second Middle East-North Africa Summit in Amman scheduled for October 1995, on the economic reforms required in the Middle East; the institutional arrangements that might be proposed to promote economic development in the region; functional matters related to water, the environment, and the EuroMed initiative; and Palestinian economic development. He had been asked to attend the meeting as a member of an advisory group, which also included Abdul Lateef el Hamad of Kuwait, Jacob Frenkel of Israel, Andre Azoulay of Morocco, and Caio Koch-Weser of the World Bank.

2. ITALY - 1994 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1994 Article IV consultation with Italy (SM/95/32, 2/9/95; and Sup. 1, 3/14/95). They also had before them a background paper on economic developments and issues in Italy (SM/95/48, 3/9/95; and Sup. 1, 3/9/95).

The Director of the European I Department noted that, on March 16, 1995, the Chamber of Deputies had approved by a narrow margin the supplementary fiscal package proposed by the Government. In the course of the parliamentary debate, some of the finer details of the package had been modified. Nevertheless, based on a preliminary assessment, the overall size of the fiscal package did not seem to have been affected significantly.

Following parliamentary approval of the supplementary fiscal package, the Government intended to proceed with other economic objectives, including pension reform, the Director said. It hoped to present draft legislation on pension reform to Parliament by the end of March 1995. However, political debate on that issue remained tense, and there were uncertainties concerning whether the pension reform plan would be approved, as well as political uncertainties regarding the continuation of the fiscal adjustment effort.

As a result of the prevailing uncertainties, the market was continuing to show signs of weak confidence, and the exchange rate of the lira had fallen to a new low of Lit 1,270 to the deutsche mark, the Director of the European I Department stated. Although the Bank of Italy might have intervened in the markets to counter disorderly conditions, it did not believe it could offset the movement of the exchange rate through a further tightening of monetary policy.

Mr. Lanciotti made the following statement:

Since last year's Article IV consultation (EBM/94/15, 2/25/94), Italy has experienced a stronger than expected economic recovery, in the context of the robust expansion in international activity and world trade, and an interruption of the downward tendency of the inflation rate. Although the recovery in demand following a heavy recession certainly contributed to feed price pressures, a major contribution came from the increase in the cost of imports, which was magnified by the depreciation of the lira.

During 1994, in an increasingly difficult political climate, the currency's weakness stemmed partly from the perception that public finance imbalances were still serious and their resolution uncertain. This was reflected in the price of government securities. Long-term yields rose from 8.7 percent to 12.3 percent in the course of the year. The differential vis-à-vis comparable German securities widened from about 2.5 percentage points in April 1994 to almost 5 percent.

The increase in interest payments on the public debt, as a result of higher interest rates, invalidated the estimates for the 1995 borrowing requirement contained in the Document of Economic and Financial Planning of last July and the Forecasting and Planning Report of September. It became necessary, therefore, to supplement the provisions of the 1995 Finance Bill through the introduction of further measures amounting to approximately Lit 21 trillion--1.5 percent of GDP.

The sharp depreciation of the lira, far beyond any equilibrium level based on competitiveness considerations, has become more pronounced in the past few weeks. The perception of a serious risk that the combination of the lira's depreciation and the acceleration in demand might have repercussions on prices--as was already apparent in the behavior of expectations and in cost-of-living data--prompted the Bank of Italy to raise official rates on February 21.

During 1994, the pace of the recovery was stronger than expected. According to the most recent figures, between the first three quarters of the year and the corresponding period in 1993, GDP grew by 2.2 percent. The recovery has been particularly evident in the manufacturing sector. The industrial production index has increased by 4.9 percent during 1994, with a strong acceleration of growth in the last quarter of the year.

The main driving force behind the recovery has remained foreign demand, as exports increased by 10.2 percent in the first three quarters of 1994. Private consumption, especially in services and non-durable goods, has also contributed significantly to the economic recovery. The process of capital formation has not been as intense as in previous cyclical expansions, notwithstanding the increase in firms' profit margins. This probably reflected residual uncertainties about the increase in demand, as well as the still sizable level of idle capital.

Despite its strength, the economic recovery has not yet impacted upon employment conditions. According to the October 1994 survey on labor forces conducted by the Central Statistical Office--which includes the workers under the Wage Supplementation Fund--employment has decreased by 421,000 persons compared with October 1993.

The decrease in employment levels has affected all sectors of the economy and has also touched the firms with the highest export-to-total sales ratio which were best able to absorb the impact of the past recession. Employment reduction has been due, in part, to the lagged response to the previous cyclical downturn, and, in part, to a shift by firms, especially those in the service sector, toward less labor-intensive processes. Given the positive trend reflected in value added in manufacturing and services, this has implied strong gains in productivity.

As a consequence of the decrease in employment and despite a fall in the participation rate due to a "discouraged worker" effect, the unemployment rate increased in October to 12.8 percent, from 11.3 percent in October 1993.

The regional dimension of the economic expansion shows wide disparities between the north-central and southern regions of the country. The export-led nature of the recovery has, in fact, mainly benefitted the industrial north.

Price dynamics remained moderate during 1994. The inflation rate, measured by the increase in the cost of living index, averaged 3.9 percent. This is the lowest annual rate in the past 25 years, although it remains above the target level of 3.5 percent. However, it appears that the process of inflation reduction that has been occurring in the recent years had come to a halt in the second half of 1994. The most recent data show that the index had registered a slight decrease in January--3.8 percent--but had subsequently risen to 4.4 percent in February.

Pressures on prices have come from the increase in commodity prices, the devaluation of the lira, and the strength of aggregate demand. These have been partly offset by the productivity gain as well as by the wage restraint stemming from slack labor market conditions and the strict adherence to the 1993 wage pact.

The lira's nominal effective exchange rate has fallen by more than 30 percent since the crisis of September 1992; the fall since September 1994, when the depreciation of the lira came to a temporary halt, is in excess of 7 percent. During 1994 the reduction in Italian assets holdings by foreign investors certainly contributed to the weakening of the Italian currency; in the same direction, the long-term process of portfolio diversification by Italian investors, which started after the capital movement liberalization of the late 1980s, may also have contributed.

According to preliminary estimates, the current account of the balance of payments has registered a Lit 25 trillion surplus in 1994--Lit 18 trillion in 1993--which accounts for 1.5 percent of GDP. The current account surpluses registered in 1993 and 1994 have interrupted the almost continuous series of deficits observed since 1980.

During 1994, the capital account registered net outflows equal to more than Lit 20 trillion. Official reserves increased by more than Lit 3 trillion.

Over the course of 1994, the monetary policy objective continued to be aimed at preventing a resurgence in inflation and fostering its slowdown. The Bank of Italy took preemptive action to counter the danger of a resurgence of inflation as soon as various indicators suggested that this possibility might materialize, raising official rates as early as August 1994. It then maintained stable conditions in the money market until the beginning of this year, within the framework of a generally restrictive stance that was reflected in a further slowdown in the already moderate growth in the monetary base and the money supply. The acceleration of consumer prices in February 1995 confirmed the more pessimistic signals coming from the indicators. The risk that the acceleration would become entrenched and perhaps even be amplified by expectations was enhanced by an immediate and pronounced weakening of the lira. On February 21, the Bank of Italy increased the discount rate by 0.75 percent, to 8.25 percent, and the rate on fixed-term advances--Lombard rate--from 8.5 percent to 9.75 percent, primarily to curb the deterioration in inflation expectations. In the next few days thereafter, yields in the interbank market rose by 78 basis points for overnight money and by 35 basis points for one-year funds; long-term yields increased by approximately 20 basis points.

In the present situation of strong uncertainty, in which expectations are liable to change suddenly, the Bank of Italy is paying particularly close attention to the variables that give advance warning of price pressures. The array of indicators used for monetary policy has been expanded in the current context of a floating lira. Their interpretation involves taking into account the changing sensitivity of profit margins to competitive conditions and exchange rate expectations, the evolution of the financial markets, and the behavior displayed by banks in fund-raising and lending.

Although the relationship between M2 and nominal GDP has generally been stable in recent years, in the final part of 1994 M2 was affected by a variety of contingent factors that altered its behavior in the short run. Among them, in particular, is banks' caution in encouraging deposits and their aim of increasing the proportion of funding liabilities in the form of bonds. This does not involve giving lessened emphasis in policy formulation to money supply targets, but rather relying on a larger series of indicators. Indeed, the monetary policy stance, as expressed in the 5 percent target for M2 that was set in October, has been confirmed, even though contingent factors might influence the behavior of the aggregate to a greater extent than in the past. This target is fully consistent with the planning framework for financial flows for 1995, which aims at reducing inflation to the level required for convergence within the European Union (EU).

Political uncertainties have not prevented the Italian authorities from persevering in the budgetary consolidation effort, which aims to stabilize the public debt/GDP ratio. The present Government is firmly committed to this goal.

The objective for the state sector borrowing requirement in 1995, announced in the Forecasting and Planning Report in September 1994, is set at Lit 138.6 trillion--8 percent of GDP. This was viewed as the minimum requirement for continued progress toward the restoration of sound public finances.

In recent months, the increased burden of interest payments opened up the perspective of a substantially larger borrowing requirement for 1995 than was envisaged in September. The difficulties with the pension reform and its postponement, although limited to six months, made such a perspective more likely, although the Finance Bill and the accompanying provisions were approved with only minor amendments in December.

The rigorous supplementary fiscal package introduced by the present Government in February aims mainly at redirecting the borrowing requirement for 1995 toward the objective announced in September, by producing a primary budget surplus in excess of 3 percent of GDP. Indeed, the goal of the supplementary package is to improve upon the September target through the stabilization of the public debt/GDP ratio in 1995, rather than in 1996. This would be achieved without considering the revenues accruing from the privatization program, for which the Government has announced a faster timetable and has extended the list of public enterprises involved.

The overall effect of the additional measures can be valued at about Lit 21 trillion in 1995--almost 1.5 percent of GDP on an annual basis--and will increase to 22.9 trillion in 1996. Three fourths of this amount stems from permanent increases in taxes and contributions. In 1996, the reduction in the yield of certain temporary measures will be more than offset by the revenue from the new permanent measures, which will be in routine operation by then.

The changes would bring the Italian tax system more into line with those in other European countries. In fact, the ratio of taxation--including capital taxes--to GDP would approach 42.5 percent in 1995, above the level of 1994 but about one and one-half percentage points lower than in 1993. The ratio of indirect taxation to GDP would rise by 0.5 percentage points, thus reducing the disparity in relation to other European countries, which was 2.4 points in 1994. The revenue measures are spread among taxpayers with the aim of ensuring a fair distribution of the additional burden.

As concerns spending, the measures will generate savings of about Lit 5 trillion in 1995. The reductions in spending involve all categories of state sector expenditure that technically allow for a reduction. As a result, the overall growth of current expenditure will be 2 percent this year, well below the inflation rate. On only one front has the Government operated in the opposite direction: it has made available Lit 3 trillion to support investment and employment in the Mezzogiorno, which was already included in the budget approved by the Parliament in December.

The reform of the pension system is well under way and the Government is aiming at presenting draft legislation by the end of March. In addition, the anticipation of the Finance Bill for 1996 is also envisaged. The Government sees both steps as necessary for the restoration of sound public finances.

The privatization program is proceeding with determination. After its launching in 1992 and some preliminary selling, at the end of 1993 the program gained momentum with the sale of a major bank, Credito Italiano, and a medium-size engineering company, Nuovo Pignone, which together garnered Lit 2.5 trillion in December alone. In the first half of 1994, two more large banking concerns, Banca Commerciale Italiana and one third of the investment bank Istituto Mobiliare Italiano, as well as a substantial stake--43 percent--of the insurance company, Istituto Nazionale Assicurazioni, were transferred, raising Lit 2.9 trillion, Lit 1.7 trillion, and Lit 4.5 trillion respectively.

Besides these leading transactions, a significant number of smaller industrial concerns were also offered to the market in 1994. In particular, the petroleum company, Ente Nazionale Idrocarburi, disposed of holdings totaling Lit 2.5 trillion throughout the year; in the second half of the year, the sale of companies in the steel and food industries accounted for Lit 1.3 trillion. Very recently, on March 14, ILVA Laminati Piani, the fourth iron and steel company in Europe for total sales and number of employees, was sold for Lit 1.5 trillion. To date, total proceeds amount to some Lit 19.7 trillion, of which about one third has accrued directly to the Treasury and the remainder to the holding companies.

By and large, the privatization process in Italy is now well in line with the experience of other European countries. In 1995 the global level of offerings from Italian privatization is expected to be near the top of the list in Europe, both in absolute terms and especially when compared with the size of domestic equity markets.

After some partial delays in the program time-table for 1994, the pace of placements will be accelerated in 1995. The second tranche of the offerings of the Istituto Mobiliare Italiano, and additional 28 percent, and the Istituto Nazionale Assicurazioni, an additional 53 percent, are planned for completion by June 1995 and the global coordinators have already been designated. State-owned concerns in the industrial sector will be sizably cut down through large-scale privatization of public utilities and energy industry companies. New legislation is passing through parliamentary procedures; if approved, it will institute independent sectoral authorities with competence in prices, quality standards, and access to the market of public utilities. Once the competent authorities are established, the majority of the electricity company, Ente Nazionale Energia Elettrica, is planned for sale by July 1995; the entire state participation in the telecommunications company, Società Torinese Esercizi Telefonici, equal to 64 percent of capital, will be offered during the fall and the global coordinators are currently being selected. Finally, the petroleum company will be sold in full, thereby including both the energy and the chemical sectors in those offered to the market; a first tranche will be placed by the end of the year.

Mr. Clark made the following statement:

The 1994 Article IV consultation with Italy comes at a time when international financial markets are operating in an environment of heightened nervousness in which uncertainty over a country's economic or political situation can elicit a powerful market reaction. In this respect, the challenge of addressing the fundamental fiscal and structural imbalances now facing the Italian authorities has become even more urgent. Recognizing that the current political climate in Italy poses special challenges, the Executive Board must nevertheless comment on whether we think the authorities are taking sufficient measures. In this regard, I agree with the thrust of the staff report; nonetheless, there are a few issues that warrant greater clarity and emphasis.

The staff repeatedly refers to an economy that is at a turning point, or on the verge of entering either a virtuous circle or a severe confidence crisis. However, the recent decline in the nominal exchange rate, the rise in government bond yields, and the existing short- and long-term interest rate differentials vis-à-vis Germany indicate that confidence has already reached dangerous levels--the issue is how to regain it as convincingly and as quickly as possible.

In this respect, I agree fully with the staff that both the original 1995 budget and the medium-term plan outlined in 1994 were seriously inadequate to address the country's public finances and debt problem. Consequently, the decision to introduce a supplementary fiscal package and to bring forward the medium-term planning exercise is welcome, particularly in view of the opportunity posed now by the economic recovery. Most noteworthy about the supplementary package is its goal of stabilizing the debt/GDP ratio in 1995. While the package depends heavily on revenue measures to achieve results, most of these will carry a permanent effect in coming years. This is preferable to temporary one-off measures, which create uncertainty in financial markets about long-term commitment.

Nonetheless, this package should serve as a starting point for medium-term consolidation beyond what was outlined in the last three-year plan. That plan relied mostly on cyclical impetus, and did not come close to the targets required to meet Italy's commitment to Maastricht, to addressing the structural component of the deficit, or to ensuring a satisfactory decline in the debt/GDP ratio. Although the staff has steered fairly clear of specific prescriptions, I would reinforce its choice of possible areas for expenditure reduction; namely, the wage bill, production subsidies, and social transfers.

Last year, this chair noted that continuous revisions to assumptions and starting points in the fiscal framework damages credibility. In this respect, basing projections on more conservative assumptions lends credibility to the process fairly rapidly. This has proven to be the case in Canada over the past two years. In Italy's present context, that would apply mostly to interest rates assumptions, particularly given the importance of debt service to the bottom line.

On the issue of public sector debt, private savers in Italy have shown a willingness and capacity to supply most of the Government's financing needs. Correspondingly, the relatively lower level of Italy's net external liabilities may have led to some complacency concerning the risks implied by the overall level of public debt. However, Italy's relatively higher level of private savings could be affected in future by demographic developments, structural changes in the economy, or the decline in public dissavings, as has occurred in other countries. Alternatively, the desire of domestic investors to diversify their portfolios away from domestic paper, in favor of foreign securities, could evolve further as a result of financial market deregulation and integration. I would appreciate any views from the staff on this possibility--certainly it supports the case for greater fiscal consolidation as soon as possible.

With respect to the budget process, the background paper illustrates the nature of the budget-setting process in Italy. Based on the experience in Canada and in several other countries that have improved budget control in recent years, I would suggest that a successful expenditure reduction process in a modern parliamentary state should draw upon the following procedural elements: a combined top-down and bottom-up approach, the former to establish parameters; one voice--that of the Finance Ministry--to set the overall targets and make the proposals for specific reductions; a committee of senior ministers to evaluate the proposed budget for balance and political appeal; a clear deadline, such as a public budget date, that forces closure on the process; the opportunity for interested parties to provide input; and a follow-on decision-making system to handle "same-year" spending pressures, which credibly forces departments to reallocate within their budgets, but also has a limited reserve for certain contingencies.

The decision to adopt a forward-looking approach based on market indicators and to increase transparency in the central bank's operations is indeed welcome. However, recent developments highlight the dangers of not conducting monetary policy within a formal medium-term framework. The informal inflation objective of 2.5 percent for 1995 has been derailed and economic agents are now naturally inclined to fear the worst. One could challenge the reasons cited by the Bank of Italy--on page 17 of the staff report--against inflation targeting. Wage setting and fiscal planning should be determined on the basis of credible inflation assumptions, not the reverse, as the text of the staff report seems to imply.

Furthermore, the central bank states that a lack of control over fiscal policy prohibits it from setting inflation targets. Although I am skeptical about that assertion in itself, does that imply that a commitment by the Government on fiscal measures would allow the central bank to set targets? If so, I would note that Italy has already made a commitment in principle to meeting Maastricht convergence targets. Having clearly identified these macroeconomic goals, could a joint anti-inflation commitment not be forged between the central bank and the Government? This would enable the Bank of Italy to set out a medium-term planning framework that would facilitate its task considerably by conditioning expectations.

On monetary conditions, a cautious approach continues to be advisable given the increase in consumer prices to 4.3 percent--year-to-year--in February, rising inflation expectations, emerging wage pressures, and the risk of capacity constraints or bottlenecks in certain sectors.

The staff's recommendations on structural policies are suitable goals, and I commend the authorities on the progress they have achieved in this regard in recent years. With respect to labor market reforms, removing the wage indexation system and establishing a more flexible wage-bargaining structure has greatly improved the functioning of the labor market and has served to contain wage increases. However, in the face of persistent high unemployment and serious regional disparities, additional measures to increase the responsiveness of regional, sectoral, and firm-specific wage differentials to market forces need to be implemented. As we have noted in the past, a high degree of labor market flexibility is necessary to facilitate the adjustment of the economy to nominal and real shocks, not to mention a necessary condition for sustainable participation in the European Monetary Union (EMU).

On the fiscal side pension reform remains a key priority, and we would encourage the authorities to persevere with the proposed reform. Further measures, however, will need to be implemented to ensure the long-term viability of the pension system. Finally, we would join the staff in advocating further tax reform, the continued divestment of state-owned entities, and additional reforms to the financial sector.

Mr. Cippa made the following statement:

It is with a sense of relief that we heard the news that the Italian Government has today won, in the lower house of Parliament, the confidence vote requested by the Prime Minister, after the difficult beginning of the debate on the supplementary fiscal package. However, political uncertainty in Italy remains very high, and the scope of the present Government to implement far-reaching reforms should not be overestimated.

As the staff stressed, continued financial market tensions did not prevent economic recovery. Beginning in end-1993, the upswing gained momentum in 1994 with a gradually increasing contribution of domestic demand. However, net job creation remained negative and unemployment continued to rise, reaching an annual average in 1994 of 11.5 percent, with sizable regional disparities. Owing mainly to wage moderation following the new collective bargaining system, the inflation rate was brought to its lowest level in 25 years. The trade balance improved markedly, reflecting considerable competitiveness gains since the exit of the lira from the exchange rate mechanism (ERM). This generated a current account surplus of 1.5 percent of GDP in 1994, accompanied, however, by an equivalent outflow of capitals that was partly confidence-driven. Erosion of confidence led to a sharp depreciation of the lira vis-à-vis the strong currencies in Europe--about 25 percent against the Swiss franc in the past 12 months--despite the steady increase in interest rates since last summer.

The severe market reaction sanctioned the inability of the Government to exploit the favorable economic climate to address decisively some deep-rooted imbalances, such as an unsustainable high budget deficit, as well as much-needed structural reforms. In particular, it was regrettable that the Italian authorities did not adhere to the original--and, indeed, not very demanding--fiscal targets for 1994. Fearing a cyclical slowdown, the authorities relaxed the stance of the fiscal adjustment allowing an overall deficit of 9.5 percent of GDP; consequently the public debt rose to over 123 percent of GDP. After a good start in 1993, the privatization program was delayed in 1994. A positive note was the conduct of monetary policy amidst very difficult circumstances. Despite the absence of reliable monetary anchors and its limited room for maneuver, the Bank of Italy was successful in pursuing a pragmatic anti-inflationary monetary policy. In particular, it provided a number of timely and appropriate responses to market developments to counteract the resurgence of inflationary pressures.

The present Government strengthened the effort of budgetary consolidation aiming at stabilizing the public debt/GDP ratio. We welcome this development, which corrects the trend of past years, although we share the staff's concern regarding the downside risks. Indeed, maintenance of the 1995 fiscal targets announced three months ago already required supplementary fiscal measures totaling 1.2 percent of GDP, in order to offset adverse movements in interest rates. The amended budget also slightly improved the fiscal outlook; if properly implemented it will allow the stabilization of public debt envisaged in the three-year program to advance by one year, to end-1995. This is consistent with an overall budget deficit of 7.5 percent of GDP in 1995 and privatization receipts estimated, quite optimistically, at Lit 10 trillion.

Although one can question the adequacy of some specific aspects of the package, such as, for instance, the increase in corporate income taxes, it is more than fair to recognize the exceptionality of the present circumstances which limit the room for maneuver of the Italian authorities. Still, there is no place for complacency; more needs to be done to convince the market that a permanent change in the direction of public finance has occurred; this must include decisive steps to improve the structural balance.

The achievement of the fiscal target relies equally on revenue and expenditure measures. We particularly welcome the introduction in the supplementary budget of revenue measures of a more permanent nature, such as the increase in value-added tax rates. This will undoubtedly strengthen the medium-term fiscal adjustment and foster market confidence. Like the staff, we are uneasy with the expected return of some revenue measures--procedures for assessing past tax liabilities, the closing of pending tax disputes, and amnesty on illegal construction--as these may turn out to depend heavily on factors beyond the control of the authorities. Moreover, given the experience made by other industrial countries, we would urge the Italian authorities to take contingency measures in case the envisaged tax reform, which shifts emphasis to consumption, should adversely affect fiscal revenues. On the expenditure side, we think that further spending cuts are definitively needed. In this regard, although we welcome the determination of the new Italian Government to move forward expeditiously in the area of pension reform, we concur with the staff that more radical measures are needed to guarantee the viability of the Italian public pension system.

On monetary policy, we are sympathetic toward the central bank's decision not to rush toward a new framework of inflation targeting. This could jeopardize its credibility, as inflation still very much depends on fiscal and institutional developments. We consider the present stance of monetary policy as adequate. In the present circumstances, a tightening of monetary conditions to underpin the lira is not advisable. Only progress in political stability and fiscal consolidation would allow the lira to appreciate.

With regard to the labor market, the staff report does not sufficiently take into account the need for specific policies to solve the structural problems of the southern regions of the country. The argument provided by the former authorities, according to which the regional differences would diminish with a shift toward a more domestic demand-led expansion, is not convincing. The expected reduction in unemployment induced by the cyclical upswing cannot take the place of structural policies to create a favorable framework for the development of the Mezzogiorno. The present Government has acknowledged this need by including expenditures of 3000 billion lira in the newest budget bill to support investment and employment in these regions.

Ms. Lissakers made the following statement:

Political and financial market turmoil in Italy in recent months has overshadowed a number of positive macroeconomic developments since our last review. Italy's growth recovery was among the strongest in the EU, inflation in 1994 was the lowest in 25 years, wage trends were favorable, and strong export competitiveness boosted the current account surplus. These bright spots are threatened, however, by the downside risks posed by large fiscal imbalances and high public debt. While these issues are longstanding ones in Italy, their associated risks have been both clarified and intensified by volatility in market behavior at home and abroad.

It goes without saying that reducing the fiscal deficit and putting public debt on a downward path must be the top priorities. The urgency of this is outlined candidly in the staff report and background papers, and I can endorse the staff's assessment. The costs of delays in the adjustment process have been high in terms of plummeting investor confidence, the sinking of the lira, rising long-term interest rates--including widening differentials with Germany--and increasing inflationary pressures. Expedited action to accelerate fiscal consolidation will be crucial to calm market tensions.

Unfortunately, the 1995 budget and three-year plan fell short of that task, fueling market volatility further. The news that the Government's supplementary budget was passed by Parliament is therefore welcome. The signal that the passage sends, however, is more important than the magnitude of the package. The main advantage of the supplemental budget is that the additional measures that it takes are permanent, as opposed to the temporary nature of much of the original budget package. The new budget projects stabilization of the debt/GDP ratio in 1995, but this seems to be more attributable to stronger growth projections than to actual policy steps. The authorities' intention to begin work early on the 1996 budget and next three-year plan is therefore encouraging. After looking at the comparison of tax burdens in major industrialized countries in Table 18 of the background paper, we would concur with the staff that the tax burden in Italy is not excessive and that additional scope exists for further revenue measures. The moderate across-the-board spending cuts in the supplemental budget, while palatable politically, fall short of what is ultimately required on the expenditure side. In short, bolder action will be needed in the 1996 budget and beyond. The authorities' commitment to accelerate privatization and implement pension reform in 1995 will be key in this regard.

Continuing exchange rate and interest rate volatility in the wake of the political impasse are the clearest indicators of the costs to the economy of the confidence crisis. The difficulties are exacerbated by the high sensitivity of Italy's public finances to interest rate developments. The technical debt management skills of the Treasury are not in doubt, but investors are nervous, and there is a heavy refinancing schedule ahead. This situation will warrant close monitoring.

With respect to monetary policy, we continue to have reservations about the staff's espousal of inflation targeting as a formal framework for determining the monetary stance. As I noted in our discussion on Italy last year, and have also mentioned in other cases, we do not see inflation targeting as the functional equivalent of targeting an intermediate objective, such as the exchange rate or monetary aggregates. Rather, it is an acknowledgement that no clear, simple intermediate rule for guiding monetary policy has worked very well. Italy's monetary authorities recognized this when they dropped the exchange rate anchor. Inflation targeting, per se, does not provide any operational guidance as to the day-to-day management of monetary policy. The Bank of Italy's stated intention to track a range of indicators with a focus on improving transparency makes sense.

The Bank of Italy raises an unusual objection to inflation targeting. It argues that it would be inappropriate for the central bank to set an inflation target because the Government is already announcing its own inflation objective. I understand the need for clear lines of authority and policy consistency, but I was surprised that there appeared to be little coordination between the monetary authorities and the Government in formulating the inflation target, an objective that is so dominated by monetary actions. The announced inflation target seems to be more of a tool for wage negotiations and government spending objectives than a reflection of monetary trends and the capacity of the central bank to maneuver. Against a government target of 2.5 percent, actual inflation registered almost 4 percent in 1994 and the staff projects a further increase to almost 5 percent in 1995. It will be interesting to see how this plays out in the next round of wage negotiations. In any case, the Bank of Italy's decision in late February to raise official interest rates seemed to be a fitting response to a range of pressures.

The analysis on the exchange rate and competitiveness in Annex V of the background paper is welcome. This should be a regular feature of our surveillance work. I can accept the staff's conclusion that the lira is currently highly competitive, even perhaps "undervalued," but I have a few questions about the analytical path that the staff takes to get there. The calculations of real effective exchange rates, whether measured on the basis of consumer prices, wholesale prices, or unit labor costs, all show that there has been a major improvement in Italian competitiveness since the devaluation. This gain has more than wiped out the deterioration in competitiveness that occurred during the late 1980s and early 1990s. Improved competitiveness has shown up quickly in better trade performance.

I was somewhat uneasy, however, with the staff's attempt to link competitiveness indicators with normative judgments about what the current account balance should be, in arriving at conclusions about "undervaluation." The starting premise for this part of the analysis seems to be that "there is no reason to believe that current account surpluses of the magnitude implied by the staff projections are appropriate for Italy at this time." This assertion is linked to the fact that Italy has an aging population. I would not put too much confidence in any close linkage between demography and current account positions but, if anything, the relation would be the opposite of that proposed by the staff. An aging population would be expected to save now and accumulate assets abroad that can be drawn down in the future when there are fewer able-bodied workers to support the population.

We should suspend judgment on whether the current account surplus is too high or too low. If we do, however, it is harder to make categorical judgments about whether the current exchange rate is overvalued, undervalued, or just right. This is not a major loss, although we do not need fundamental equilibrium exchange rate calculations to come to useful conclusions about whether policies are consistent with internal and external balance and exchange market equilibrium. The staff has made a clear case that the weakness of the lira is closely associated with fiscal policy distortions. Furthermore, improving the stance of fiscal policy is likely to strengthen the lira but it is also likely to have an ambiguous effect on the current account balance. Less dissaving in the government sector may be partially offset by weaker saving in the household and corporate sectors. Furthermore, less of a risk premium on Italian assets may make both the lira and investments in Italy more attractive. The net of all on the overall savings/investment balance is unclear.

This leads to another point. It would have been useful to have some discussion of the factors behind Italy's relatively high private savings rate. I noted one or two references in the papers to an estimated increase in gross national savings in 1994, but could not find anything on the magnitude of the increase or the factors behind it. While the staff report's medium-term projections include estimates from 1994 on, inclusion of historical trends in the background papers would have been useful.

I welcome the attention devoted in the staff report and the background paper to employment and unemployment trends, including future projections. The analysis suggests that labor market reforms have increased the elasticity of employment to output, but it is not yet clear that this is true in both directions. The fact that unemployment rose further in 1994, even as the recovery was becoming more firmly established, highlights the priority that must be placed on a comprehensive, coordinated approach to labor market reform. Steps taken since the last consultation to reduce labor market rigidities, such as increasing flexibility in private sector contract renewals and looking to enhance wage differentiation in the second-tier negotiations, are encouraging. I share the staff's view, however, that bolder efforts are needed along the lines of the recommendations put forward in the staff report.

Finally, the chapter on the Italian public pension system in the background paper outlines in a clear fashion the complexities of the system and the enormity--as well as the urgency--of the task for reform. I found the various levels of sensitivity analysis for a range of reform measures and the country comparisons particularly illustrative, and a useful reference as pension reform in Italy evolves. The December agreement between the Government and trade unions to move forward with broad-based pension reform in 1995 should lay the foundation for the type of comprehensive approach that is needed.

Mr. Schoenberg made the following statement:

We generally share the staff's assessment that fast and forceful action is necessary in Italy to reduce uncertainties, to restore confidence, and to make rapid and durable progress in fiscal consolidation. This should indeed be a matter of overriding national interest and shared responsibility for the authorities. Unfortunately, some important players in Italy's political team still seem to lack awareness of the graveness of the situation. If the confidence crisis is not resolved soon, Italy could slip into a full-fledged financial crisis with severe repercussions for the--until now--relatively stable and prosperous private sector. The time-consuming squabbles over the supplementary fiscal package, which is rather unambitious compared with the magnitude of Italy's fiscal problems, make it very hard to retain any sense of optimism.

Mr. Lanciotti was correct to stress that the recent depreciation of the Italian lira has gone further than economic fundamentals would suggest. Purely economic measures, such as further increases of interest rates, will, however, not be able to stabilize the Italian currency unless such action is backed by an adequate showing of political responsibility. Monetary policy can, at this point, only hope to prevent a downward spiral of inflation and depreciation. It is up to fiscal policy to contain domestic demand at a level compatible with stable prices. Fiscal policy also must stabilize expectations about future tax and debt developments. While we certainly believe that it is premature to draw parallels between Mexico and Italy, as has been done in the international press, it is more than obvious that the unfavorable maturity structure of public debt, the high vulnerability of the budget deficit to increases in interest rates, and the deficit in the capital accounts increasingly reduce the authorities' room for maneuver and, if unchecked, will harm growth prospects.

We do not share the authorities' optimism about the financing of the budget deficit and the refinancing of public debt. As the worsening inflation outlook reduces real returns for investors in Italian debt, these will either demand even higher interest rates or switch at least some of their funds into other markets. In this connection it would be interesting to learn from the staff how capital movements have evolved during the first three months of this year. Anecdotal evidence suggests that the depreciation effects of capital outflows are magnified by the reluctance of Italian exporters to repatriate export earnings into Italy; by keeping export earning in foreign currencies, they earn additional depreciation profits. Italy's export success, therefore, fails to stabilize the lira. This might force the central bank to increase interest rates even further, in order to increase opportunity costs for such flight capital. Higher interest rates, however, will further increase the budget deficit, whose magnitude is one of the leading reasons for capital flight in the first place. I may add, in this context, that the recent Mexican experience indicates that a quickly improving current account can be mainly the result of strong capital flight.

While we agree with the staff and Mr. Lanciotti that the scope of emergency measures is necessarily limited, this by no means reduces the pressure on the authorities to radically reduce fiscal deficits much further than hitherto anticipated. In this connection, I was quite disappointed by the unambitious medium-term fiscal targets. If Italy wants to escape the recurrent fiscal and financial crises, a mere stabilization of the debt/GDP ratio during the next five years, as indicated by the medium-term scenarios, is not enough. It is well known that Italy's overly generous and highly subsidized pension system is the linchpin to a stable financial future. In contrast, Italian tax rates are already among the highest in industrialized countries. Any additional revenue measures would therefore have to depend on a broadening of the tax base, which is small compared with that of other countries.

We basically support the staff's recommendations regarding monetary policy. Italy is indeed in need of a nominal anchor, a role that the exchange rate has ceased to play since the departure of the lira from the ERM. In this connection I especially welcome the staff's acknowledgement of the suitability of a single intermediate monetary target consistent with medium-term price stability. While Mr. Lanciotti tries to preserve the impression that money supply targets continue to play a central role in monetary policy formulation, the staff report indicates that the authorities have largely given up on that concept. The staff therefore suggests the introduction of inflation targets established in a medium-term monetary framework. However, inflation targeting is, as Mrs. Lissakers observes, no functional equivalent of targeting an intermediate objective, because it does not provide concrete operational guidance as to short-term management of monetary policy. Incidentally, much of the same holds true, of course, for a large range of indicators, which allows for considerably discretionary leeway for policymakers and makes it difficult for markets to assess whether the central bank is really on track. My main point in this regard, however, is that an approach suitable for the Federal Reserve may not be also an approach suitable for the Bank of Italy, given the independence and recent inflation-fighting record of the former and the low level of market confidence confronting the latter.

With respect to inflation targeting, the staff has, in addition to the theoretical weaknesses I have mentioned, identified a high practical hurdle that the Italian authorities would have to conquer, namely, that after specifying a target for inflation, the public has to be convinced that this target was foremost in the authorities' formulation of monetary policy. However, considering the fact that the inflation targets are, at present, apparently established by the Government and the Parliament, rather than by a fully independent central bank--and in view of the expected rise in inflation during this and the coming year--it might prove difficult to convince the public at this time that inflation targets are worth the paper they are published on.

Mr. Ismael made the following statement:

Let me begin by touching upon the situation left behind by the previous government. Inflation during 1994 remained encouraging, largely because wage growth remained very soft. Falling real wages and a weaker currency were behind Italy's strong export performance as well. This trade performance would have provided support for the lira had the political background been calm, and had confidence that inflation would remain in check been bolstered by further fiscal tightening. Although the previous government had initially announced pension reforms to bring about expenditure restraint, these reforms had to be watered down in order to ease the passage of its budget through Parliament and avoid a general strike. The end results were a larger deficit than had been hoped, a significant loss of fiscal credibility, and doubt about the sustainability of the low inflation rate.

Having said that, a new Government was meanwhile endorsed by the Senate in early February 1995. While the Government has changed, the questions it is confronted with remain the same: can the new administration deliver on its pledges to reform the pension system, media, political regime, and fiscal policy? In addition, will the political landscape evolve in a manner which proves sufficiently stable to allow solutions to structural problems to be sought over the medium term?

When we look at Italy's fiscal performance over the past years, fiscal overruns have averaged between 0.5 percent and 1 percent of GDP annually since 1988, and 1995 appears to be no exception. As a result of overly optimistic economic assumptions, such as an average short-term interest rate of 8 percent and inflation of 2.5 percent this year, the deficit will be pushed up by as much as Lit 25 trillion. I welcome the recently announced "mini", or supplementary, budget totaling Lit 20 trillion to reduce the budget deficit. Unfortunately, most of the savings come through a variety of tax increases that would continue in 1996. I also note that to stabilize the debt/GDP ratio, a primary surplus of nearly Lit 70 trillion will be needed, compared with Lit 15 trillion in 1994. This clearly shows that further deficit cuts will be needed in the autumn budget.

To achieve the necessary deficit reductions, I agree that structural reforms ultimately will be essential. In this regard, pension reform is indeed vital, as Italy's unfunded pension liability position appears unsustainable. At this time, the authorities appear to have union support, but more radical measures, including bringing the retirement age and rate of pension qualification in line with the European average and reducing Italy's generous level of benefits, will remain politically problematic. The question is whether the new Government--being a technocratic, but still a caretaker, government--will be more successful than its predecessor in resolving this controversial issue. Perhaps the staff could comment on this issue.

In conclusion, if disappointments on fiscal policy result in additional currency weakness, monetary policy should probably be tightened to ward off potential inflationary pressures--which for now remain subdued--in the months ahead.

Mr. Mesaki made the following statement:

The staff was correct in warning that the Italian economy was vulnerable to shifts in market confidence. Unfortunately, this concern has already been validated by the downward pressure on the lira exchange rate. This partly reflects the unexpected deterioration of the market confidence in general after the Mexican crisis; in that sense, Italy was unlucky not to have been given enough time to cure the basic problems of its economy. Nevertheless, the market is not to be blamed; we all know that the worry of the market has at least some ground in Italy. It is to be hoped that the authorities will gain as many lessons as possible from this experience.

The appraisal of fiscal policy was appropriate when the staff report was written. Let me reiterate some points for emphasis. Although the value of a fiscal consolidation "plan" cannot be denied, it will not enhance anyone's confidence if it is not bold enough and lacks specificity as to the measures for achieving it. It must be recognized that their bad record, illustrated in Chart 7, is a heavy negative asset. The consolidation effort should be hastened beyond the targets of the current three-year plan, and greater specificity is required with respect to the envisaged measures. Moreover, the heavy reliance on one-off measures is in effect a postponement of the fundamental solution of the problem. This indeed casts doubt as to the sustainability of fiscal consolidation. What is required is a set of concrete and long-lasting expenditure-cutting and revenue-enhancing measures with which the authorities can express their determination to the world. From all these perspectives, the corrective budget package recently introduced by the Government is welcome as a first step in the right direction. It is bolder and more specific than the original budget package and it relies mostly on permanent measures. Therefore, it is very encouraging to learn that the budget obtained the approval of the lower house of Parliament.

Monetary policy is expected to play an important but difficult role when the declining lira exchange rate puts upward pressure on the inflation expectation, and political uncertainty prevails. In this respect, I welcome the forward-looking attitude assumed by the Bank of Italy in raising its official discount rate in August 1994 and in February 1995. The improvement in the fiscal condition will give some relief to the Bank of Italy, but for the moment the Bank will have to carefully observe the developments in the markets and in the economy as a whole. As to the medium-term monetary policy framework, I agree with the authorities' views that, at least in the near term, it is not appropriate to adopt a formal inflation-targeting framework. Uncertainties still surrounding fiscal policy and the political nature of the Government's inflation targets suggest that such a framework is premature. It should be noted that setting a formal target and then breaking it is often worse than doing nothing.

I would now like to turn briefly to exchange rate policy. If today's discussion had been held several months ago, I might have been sympathetic to the argument of the authorities--supported by the staff--that the lira had been undervalued. Now, however, with a further decline in the lira rate, I am preoccupied with the difficulty of assessing the equilibrium exchange rate. The staff's assessment, which is described in the staff report, seems to be based mainly on the current account balances and the historical developments in the real effective exchange rate. This raises the question of whether the staff thinks that the lira's undervaluation is worse now than in the past.

On structural policies, I am encouraged by the progress made in such areas as wage flexibility and privatization. I agree with the staff that, in order for the economic recovery to have a visible effect on employment, a bolder approach is needed. I would especially like to emphasize the importance of the reform of the unemployment benefit system, which will also contribute to fiscal consolidation.

Mr. Autheman made the following statement:

Our discussion will reflect the limits of our surveillance. The staff report is excellent, and I am referring both to the report itself and to the set of background papers, which reflect a very intense process of consultation with the authorities and continuous wisdom in our advice.

The conclusion is that our efforts and advice globally fall short of what is needed; and what is needed, as rightly pointed in the last sentence of the supplementary report, is strong action "in order to dispel uncertainty, restore confidence, and make rapid and durable progress in fiscal consolidation, which is a matter of overriding national interest."

I am not confident that, even if it is skillfully implemented, the present discretionary approach followed by the authorities will be sufficient to dispel uncertainty and restore confidence. I am especially concerned about the extent of the lack of credibility of Italy at this stage--ahead of a period of rising interest rates in Europe and at the end of a period of declining interest rates in Europe--which means that, far from helping Italy, the external environment will increase the pressure on Italy within the next two or three years.

Against the background of the very uncertain political environment, the skills demonstrated by the authorities are impressive, as evidenced by the Prime Minister in getting his supplementary budget package approved and by the Bank of Italy in maintaining a standard of high quality and some confidence, in spite of the lack of predictability of Italian policies.

But I do not see how a discretionary approach, which might have been helpful in a period of recession, low inflation, and low interest rates in Europe, could help Italy to achieve much progress in the coming months and years.

As the staff report rightly points out, the conduct of monetary policy during an upswing would now be tested, and I am afraid that market signals tend to indicate that it will be tested very seriously. Italy seems to be condemned to a period of very high interest rates, reflecting both the expectation of further exchange rate depreciation and of a very high inflationary risk, as well as the need to ensure a significant real interest rate premium to prevent Italian households from substituting foreign assets to government bonds.

Thus, I wonder whether we should not go a step further in our advice and indicate clearly to Italy that what is needed is a firm medium-term framework for monetary and fiscal policy, setting binding objectives and allowing markets to compare future performance against predetermined criteria.

It is up to Italy to decide whether it will be able to develop such a framework on its own, whether it should consider seeking the support of its European partners, or whether it should follow a different approach.

I agree with the staff that, in these circumstances, re-entry in the ERM and the related fixing of a central parity are not a viable option, even with the 15-percent band. But this conclusion, knowing that the lira is probably undervalued and will continue to depreciate further, means that we are not confident that the present framework of fiscal and monetary policies is able to restore credibility. And I do not see what would be the relevance of playing with fictive targets, such as inflationary targeting of monetary policy, which would not, in my view, increase credibility in any way.

We welcome the efforts made by the Prime Minister against this very difficult background, and are aware of the difficult political situation that he is skillfully dealing with. However, we should make it clear that, without a binding medium-term framework for monetary policy and fiscal policy, confidence cannot be restored.

Mr. Jonáš made the following statement:

One of the authorities' major achievements during the past year has been a significant reduction in the inflation rate, which is even more remarkable in view of the large depreciation of the lira. Another positive development is the relatively strong recovery, even though I would not say--as Ms. Lissakers did--that Italian growth is among the strongest in the EU. In 1994 it was less than the EU average of 2.8 percent. Among other positive achievements, I would also note Italy's progress since 1990 in increasing the competitiveness and openness of financial environment.

As in previous years, public finance deserves most of our attention. Last year I questioned the authorities' intention of waiting for a strong recovery to begin before undertaking debt reduction. Paradoxically enough, it now seems that fiscal weakness may have helped the recovery. By undermining the value of the lira, it helped boost net exports without doing much damage to the investment component of aggregate demand, owing to its relatively low sensitivity to interest rates. Now, however, the surge in net exports seems to have peaked, as Italian exporters have established their market shares and the positive growth effects of the weak fiscal balance may be exhausted.

More worrisome now is the fact that in spite of higher than expected GDP growth and a lower than expected average interest rate on public debt, the 1994 budget ultimately registered a deficit exceeding both its original and its revised targets. A further weakening of the structural primary balance, even at this stage of the cycle, would call for a much stronger fiscal adjustment effort than the authorities have planned. The first priority should be the implementation of a credible medium-term fiscal program. The measures outlined in the "minibudget" are encouraging, but I still see several reasons why the total fiscal measures planned for 1995 may not be sufficient to establish the credibility.

As Mr. Cippa noted, a large part of the 1995 budget package relies on the voluntary compliance of taxpayers, over which the authorities have little direct control. This large dependence on voluntary compliance introduces a degree of uncertainty that is not necessarily fully consistent with credibility. The risks are increased by the absence of any real threat of sanctions for those who do not comply with amnesty proposals, which also introduces an element of moral hazard, as there may be a reduced incentive for people to comply with future tax obligations.

A second cause for concern is the outlook for interest rates. The size of its public debt makes Italy very vulnerable to interest rate changes. This weakness is compounded by the fact that a relatively large share of public debt carries floating interest rates, as well as by the fact that much of it has a short-term maturity. As a result, the recent increase in interest rates can easily jeopardize achievement of the 1995 fiscal targets. I therefore welcome the authorities' efforts to reduce the budget's sensitivity to movements in interest rates by lengthening the maturity of the debt and increasing its fixed rate component. However, the most effective way of reducing interest rate vulnerability would be to draw up a credible medium-term debt reduction program that would increase confidence, exert downward pressure on interest rates, and allow the Treasury to issue long-term debt at more favorable rates.

On balance, the effects of the lira's depreciation from 1992 to 1994 have been positive so far, permitting export growth to fuel an economic recovery without adding to subdued inflationary pressures. However, it is not certain that this favorable balance will continue. The growth of net exports has already fallen off, and there are signs that inflationary pressures are reappearing. The lira's loss of about 12 percent against the deutsche mark in the past two months poses a definite risk of rekindling inflation. In February the central bank responded correctly by raising interest rates, but based on the response of financial markets, it should be clear by now that without progress in the fiscal area, monetary policy may not be able to neutralize these risks. On the question of a framework for monetary policy, I would support the argument that the introduction of an explicit intermediate target can enhance its predictability, but unless a positive track record of fiscal consolidation is established, we should not expect miracles from a more formal framework of monetary policy.

Finally, the persistence of high unemployment shows that the existing distortions in the labor market still prevent the unemployment rate from responding sufficiently to the business cycle. This unfavorable development indicates the need to address the remaining structural weaknesses of labor market and increase its flexibility. I was also surprised that the abolition of wage indexation and the subsequent sharp reduction in the growth of wages and unit labor costs coincided with an abrupt decline in employment and continued high unemployment. The staff's comments on this apparent paradox would be welcome.

Mr. Wijnholds made the following statement:

The main policy issues confronting Italy are well known and clearly set out by the staff, which refers to the recurrent theme of an unsustainable government budget deficit and the need to reduce the much-too-high level of public debt in relation to GDP. As I am in broad agreement with the appraisal, I will not cover all the relevant points in my intervention.

It is rather striking that, despite all its difficulties and the atmosphere of near crisis that has prevailed on and off during the past 12 months, the Italian economy has re-emerged on the path toward robust recovery. Indeed, one must admire the authorities' ability to balance on the brink. A strong export performance, aided by the massive depreciation of the lira, has been the main contributing factor, although domestic demand has recently been recovering also. In the staff's judgment, with which I concur, the lira has become undervalued. The current account surplus is even projected to exceed 2 percent of GDP this year, which is a lot for a country that has a long tradition of external deficits. Incidentally, Germany, which has the reverse tradition and is one of Italy's main trading partners, remains in a relatively modest deficit position.

It should be obvious that Italy's ongoing economic recovery is at risk if political and financial stability is not restored; in particular, it is regrettable that the economic upswing has, until now, not been used to initiate a correction of the fiscal imbalances. It is of the utmost importance, in the prevailing circumstances, that the Italian authorities restore fiscal credibility so as to prevent a financial market-induced crisis, which might lead to a further outflow of capital and depreciation of the Italian lira, causing interest rates and the inflation rate to rise. In the course of 1996, these risks will be even more evident, as the output gap will have declined and the wage agreement of 1993 will have to be renegotiated. The credibility of Italian fiscal policy cannot be restored by fiscal programs that are based on optimistic growth and interest rate expectations, a point that has been forcefully made by Mr. Clark. Indeed, it would be appropriate to incorporate more cautious growth projections when drafting the medium-term financial framework for 1996-98. It should be noted that more ambitious measures than already envisaged in the medium-term financial plan for 1995-97 would then be necessary in order to achieve the EMU public finance criteria in 1998.

Adequate coverage has been given to the high level of Italy's public debt and the urgent need to bring it down. It is, however, also desirable to cast an eye on the debt management aspect. Here, improvements have been made, to which the staff refers in its supplementary note. Still, the fact that a large part of the public debt has a short- or medium-term maturity makes the rate of debt accumulation very sensitive to interest rate developments. It is also striking to learn that nearly one half of the total debt is maturing this year. The authorities should therefore be encouraged to further lengthen the average maturity of the public debt and smooth the pattern of debt issues and repayments.

The new Government's fiscal package, which relies heavily on indirect tax increases, will tend to push up the inflation rate in the course of 1995. The staff mentions that the consumer price index figure could increase to between 4 1/2 percent and 5 1/2 percent, which would imply roughly a doubling of the official inflation target. In this context, the arguments put forward by the central bank, during the policy discussions with the staff, against adopting a formal inflation-targeting monetary strategy, are reinforced. The monetary policy strategy of the central bank, which is aimed at monitoring a set of indicators to detect inflationary pressures, seems to be warranted in the prevailing circumstances. Indeed, as inflationary pressures built up, the central bank tightened the monetary policy stance in August 1994. However, I agree with the staff that the monetary policy strategy pursued should be transparent and provide a reliable basis on which the public can form expectations.

The staff is correct to conclude that, in the present circumstances, targeting the exchange rate is not an appropriate monetary policy strategy for the central bank. Appreciation of the lira is dependent on a reversal of the skepticism regarding the prospects of fiscal adjustment and of implicit inflationary expectations, and should not be pursued through monetary policy. Nevertheless it would appear that, if depreciation of the lira were to cause further inflationary pressures to build up, a restrictive monetary policy would be called for, as noted by Mr. Ismael.

Mr. Mozhin made the following statement:

This is, clearly, a critical moment for the Italian authorities' efforts to bring about the required turnaround in public finances. After the decisive steps undertaken in 1992-93 which allowed the achievement of a positive primary balance of the general government for the first time in recent Italian history, in 1994, the authorities accepted a back-tracking from the previously intended path of fiscal adjustment. It would be highly regrettable if the window of opportunity provided by the robust European recovery were not fully utilized.

With this in mind, I welcome the initiative of the administration of Prime Minister Dini introducing a supplementary fiscal package aimed at stabilizing the debt-to-GDP ratio in 1995, without any further delay. It is true that the design of this fiscal package is not ideal, with three fourths of the total falling on the revenue side and the one remaining fourth consisting mostly of across-the-board spending cuts. However, we all know that this whole initiative was undertaken in an emergency situation under quite difficult political circumstances and, therefore, deserves our full support. I also welcome the intention of the authorities to speed up the implementation of the privatization program and the approval of the pension reform.

In the supplement to the staff report, the projection for the rate of inflation in 1995 is revised upward from 4 percent to 4.8 percent. It is also mentioned that, depending on the lira exchange rate behavior, consumer price inflation in 1995 could range between 4.5 and 5.5 percent, and that this may have quite negative implications for the second-tier wage negotiations scheduled for late 1995. I wonder whether this scenario is not based on pessimistic assumptions regarding the fate of the supplementary fiscal package. The approval of the package by Parliament should send a strong positive signal to the financial markets, which could lead to a marked appreciation of the lira. This in turn could lead to a reduction in interest rates and could further strengthen the fiscal position and output performance. In other words, I wonder whether the possibility of the virtuous circle still exists, and I would appreciate staff comments on this.

In my opinion, one of the most interesting parts of the staff report is that describing the monetary policy discussions between the Italian monetary authorities and the staff. I can understand the monetary authorities' concern that, under the current political and fiscal circumstances, the formal inflation targeting could put the credibility of the Bank of Italy at risk. Paradoxically, this whole situation makes the Italian monetary authorities content with the present institutional arrangements, when inflation targets are being established by the Government and approved by Parliament, although this clearly undermines the role of the Bank of Italy in formulating monetary policy.

With respect to labor market policies, the abolition of the Scala Mobile in 1992 was clearly a decisive step forward. However, this was only the first step; a lot more remains to be done, and I fully concur with the staff analysis and recommendations on this subject.

As I recall from my history course, the word "bank" originated from the Italian word "banca" or the bench on which medieval Florentine merchants used to sit while settling their financial transactions. At that time, the Florentine currency, the florin, was the main reserve currency and the anchor currency for the rest of Europe. This story reminds us of the pioneering role that the Italian financial institutions played in the development of the modern financial system. With this in mind, I strongly believe that the Italian authorities will derive their inspiration from the experience of sound public finances of medieval Florence, rather than from that of the profligate spending practice of the late Roman Empire.

Mr. Shields made the following statement:

The staff report skirts over the essential issue for monetary policy, namely, the difficulty of tightening policy through an increase in interest rates when there is a sizable fiscal deficit financed at very short maturities. As the central bank is only too aware, increases in interest rates do not necessarily have a restrictive impact on the economy in the short-term. Market confidence can be hit by the direct impact on the fiscal deficit and can produce perverse exchange rate effects. The household sector, which is a substantial net creditor, can benefit from a higher level of net interest income and, aided by its low dependence on short-term borrowing, can actually increase its spending.

This paradoxical effect explains much of the reliance in the recent past on wages policies: only an implicit or explicit concordat providing lower nominal interest rates in return for a moderate wage outcome could deliver up both lower inflation and a relatively stable exchange rate.

This raises two issues for consideration. First, is there any realistic prospect of--or should one even be encouraged about--a further wage agreement when real wages will have been cut substantially since the 1993 pact? Second, with the central bank revelling now in full independence, would it not be better for it to stand completely back from involvement in any government wage pact?

I have no answers to these questions, but would have liked to have seen a more persistent effort by the staff to find some. In their absence, we are simply left with worries about the inflation outlook, approval of the last rise in interest rates, and concern about the short-term outlook for wages.

In fact, inflation prospects could be dreadful. If the lira does not recover substantially soon--and this morning's performance looks nothing but ill--the pass-through of the current set of increases in import costs and resurrection of margins will produce substantial upward pressure whatever happens to unit wage costs. The miracle that Italy, together with the United Kingdom, Sweden, and--to a lesser extent--Spain managed to achieve after the substantial depreciations of 1992 will not recur: there are no domestic or European-wide recessions to temper the effects of depreciation this time. Inflation will rise.

I have no solutions, but we must surely offer some advice. If the fiscal process is brought under control and a virtuous circle is about to be re-entered--fine. But, the central bank cannot assume this will be the case. Therefore, an appropriate response would be to send further warning shots in the way of higher interest rates at the least sign of any further turbulence in the markets, worse fiscal figures, or higher wages. This will at least reinforce the message that no relaxation of fiscal policy can be contemplated and that wage bargainers must remember the lessons of what high unemployment can do to their bargaining power. The central bank must make it clear that aberrant wage behavior will simply lead them back into even higher rates of increasing unemployment.

Thus far, the direction of policy is clear. But what about its magnitude? Here, one is faced with a problem of having no quantified targets. It is all very well for the central bank to be concerned about not getting stuck with an overambitious government monetary target and for Directors around this table to worry that the Bank of Italy should not promise what it is not in itself in a position to deliver. However, there is no reason why it cannot clearly incorporate contingencies. And who else is there but the central bank to provide the signals for the private sector? Furthermore, on what other basis should the central bank make its decisions? In looking for possible guidelines, one could think in terms of accepted premia over Bundesbank interest rates or some reaction to falls in the exchange rate, but use of a forward-looking inflation target would seem the most operational, in the absence of any stable money-demand function. That needs, as a priority, to be agreed with the Government. I do not see it as the answer to all monetary problems, but I do see the lack of any nominal anchor for the most, perhaps only, respected institution in Italy as severely limiting its capacity for decision-making or explaining itself. And only if it does explain itself well can the adjustment costs of preventing a rise in inflation be kept down.

Another puzzle about the Italian economy that is not raised explicitly in the staff report is the persistence of a very high savings ratio by the household sector. This is one of the factors--though clearly the exchange rate is crucial--that has allowed it to keep a healthy current account position, even with an enormous public sector deficit. We do not seem to be much nearer to understanding why savings ratios differ so much between countries, but I would suggest that the way in which housing is financed in Italy may well be an important factor. This reflects the tendency to build up family savings in expectation of housing needs, and to rely much less on mortgages. The question is: how long will this last? With an opening-up of domestic financial markets and, perhaps--although I am not an expert in social developments--a weakening of family ties, there could well be in the future structural moves toward higher borrowing by the household sector. With a decline in household savings, who will then take up the public debt, which is nearly all currently in domestic hands? Did the staff pursue this issue with the authorities?

This leads me to the third issue I would have liked to have seen explored. Can we really be confident that the relatively low exposure of the public sector to foreign holdings is a source of stability? In view of the enormous amounts of public debt that needs to be rolled over, and the high awareness by the public of the vulnerability of the lira, is there not the possibility of a serious debt strike by the household sector, even in advance of a decline in net savings? Could households not opt in a major way for overseas assets, thus accelerating the trend that Mr. Lanciotti tells us has been in motion in the private sector since the late 1980s. And where would this leave Italian interest rates and the lira? I would have liked to have seen some fuller presentation of the maturity structure of public debt and an analysis of the risks of a domestic financial crisis even beyond what we have already seen. I take encouragement from some of the factors in the supplementary staff report, but not enough.

Of course, the state of the financial markets has inhibited the climate for a fast disposal of public sector assets. However, as the staff report hints, there have been other institutional impediments to the privatization program. I wonder whether the staff might have more to add about what they think are realistic targets for privatization, in view of both the past record and the expressions of renewed determination issued by the current authorities and listed by Mr. Lanciotti. Also, should Italy have increased surveillance or enhanced monitoring? How useful has Fund policy advice and technical assistance been over the past year?

Mr. Schoenberg said that he agreed with Mr. Shields that recent exchange rate developments increased the risks of a worse outlook for inflation than those underlying the current staff projections. In such a situation, the Bank of Italy would face the dilemma of either having to modify a relatively high inflation target or having to announce a moderate inflation target that could easily be overshot. Taking either route could have very negative implications for the authorities' credibility.

The point raised by Mr. Shields on the extent to which the central bank should take into account wage developments and/or fiscal behavior in formulating its policy was very interesting, Mr. Schoenberg noted. If inflation was considered to be a monetary phenomenon, the Bank of Italy could set the monetary framework in advance by making clear what level of liquidity would be available. Such a stance would place the responsibility for fiscal and wage developments squarely on the shoulders of the Government and the wage partners. If the fiscal targets were not met, interest rates would rise; if higher wage increases were agreed, the level of unemployment would rise. Based on those considerations, the central bank would be well advised to set an appropriate monetary framework without regard to the likely plans of the Government, employers, or trade unions.

Ms. Srejber made the following statement:

At the risk of throwing stones while sitting in a glass house, I will comment on developments in Italy. At the outset, I agree with other speakers that the political situation in Italy poses special challenges. The case of Italy once again shows the importance of achieving confidence and trust in the policies set by the policymakers, particularly as uncertainties during and after the period of the recession have negatively influenced the economic behavior of households and industries. Obviously the markets are not positive that Italy's policies are set clearly in the right direction. As we all know, the fiscal situation has become particularly disturbing to the markets, especially in the present political situation.

My starting point is the same as the staff's, namely, that the original budget for 1995 and medium-term plan were seriously inadequate. After a positive development in 1993, with a fast-falling structural deficit and a primary balance that moved into surplus as many parts of public expenditure were brought under control, the fiscal development in 1994--and so far in 1995--has been less satisfactory. The 1994 fiscal deficit was much higher than planned--9.5 percent compared with the original target of 8.3 percent and a later target of 8.8 percent in the 1993 three-year plan. Furthermore, the reason for this slippage was a lower primary surplus than the targeted 2 percent of GNP, even though that target was not especially ambitious from the beginning, as it included only an unchanged primary surplus compared with that of 1993. Apart from the fact that activity was lower than forecasted, these slippages depend on expenditure controls and rationalization measures that are not fully effective. Thus, Italy enters 1995 with an even heavier backpack.

Already, earlier emergency packages have relied heavily on revenue increases to deal with the budget problems. Now, in order to get back on track toward the targeted 8 percent deficit for 1995, an emergency package has been suggested, which again relies to a large extent on revenue-increasing measures. Here, I do not totally share the staff's relaxed attitude toward the structure of the package, as it is an emergency package. This package has to be seen in the context of earlier budget measures, the necessity to curb tax evasion--which is not made easier with the higher tax ratio--and future growth effects. Although I do, of course, agree that it is better to do something than nothing. As pointed out by other speakers, it is also important that, as the effects of some of these revenue-enhancing measures depend on the behavior of the taxpayers, the risk for slippages cannot be disregarded. I agree with previous speakers that the supplementary fiscal package proposed by the Italian authorities is only a starting point for a bolder medium-term consolidation plan. There is a need for a substantial and long-lasting decline in the debt/GDP ratio over the medium term. It is clear that the authorities cannot afford to rely on the business cycle in setting the needed pace of debt stabilization and debt reduction.

Thus, the restoration of the target to stabilize the government debt/GDP ratio in 1995--it was previously moved to 1996--is, of course, welcome. Higher growth could make this possible, if revenue increases are kept on track--including privatization revenues--and interest rate payments do not once again increase expenditures more than foreseen. But the political uncertainties, and the so far insufficient fiscal consolidation, might lead to continued high--and maybe even higher--interest rates, creating a risk of slippages from the expenditure side as well. This points to the necessity of political stability and further fiscal consolidation to increase confidence. A credible fiscal program could have a notable positive effect on confidence, inflationary expectations, interest rates and, consequently, on economic activity.

The increased confidence created by a faster consolidation would also make the task of the Bank of Italy easier, as it would lessen the pressure on the lira and allow for an appreciation that would pave the way to a less-dual economy and lower inflationary pressures.

As to the inflation prospects, the recent hike in headline inflation is worrisome, even more so as the markets forecast a higher increase in inflation in 1995 than the staff. Continued wage restraint and significant productivity increases will partly cushion the hike in import prices in 1995, but domestic demand developments and producer price increases will already push up the underlying inflation rate considerably in 1995. Adding to this, the increases in headline inflation, owing to, inter alia, increases in indirect taxes most certainly will affect wage demands, as unions are allowed to demand compensation if actual inflation rates exceed those forecasted. This does not make the inflationary outlook for 1996 look good at all. Furthermore, with the present lack of confidence weighing heavily on the lira, the Bank of Italy has a very difficult task in counteracting these inflationary pressures. Monetary conditions--effects of both exchange rates and interest rates in Italy--are still very expansive at a magnitude of close to 3 percent. This is not unnoticed by the markets, which perceive--perhaps wrongly--a reluctance to tighten monetary policy, which puts further pressure on the lira. I agree with Mr. Shields that the lack of clarity on what guides the Bank of Italy in its policy decisions might worsen the situation. With respect to monetary policy targets, in a first-best world, it is best to have a workable intermediate target, be it the exchange rate or a stable monetary aggregate. However, if that first-best solution is not available, a second-best solution is better than no solution at all.

Structural reforms must be given high priority in the period ahead to support the macroeconomic stabilization process. The focus of the Government on the transformation of the state enterprise system is very welcome in this respect. However, taking into account the decrease in employment and the high and rising level of unemployment, from 11.3 percent to 12.8 percent in one year, I would welcome staff elaboration on the possible impact of the privatization process on this very sensitive problem.

In conclusion, the negative risks for Italy might be even larger than indicated by the staff report. It is to be hoped that the Italian authorities will take these risks seriously, and decisively embark on a path toward a virtuous circle.

Mr. Kannan noted that a strong fiscal reform effort was clearly needed to place the economy on a durable path toward recovery. Considering the scenario of rising interest rates, it would be important to stabilize the debt/GDP ratio, especially given the public debt of 125 percent of GDP, with relatively short maturities. In light of the current risks to the public finances, that effort was going to preoccupy the authorities for some time.

There was a time when the Italian authorities had recognized that each percentage point increase in interest rates added Lit 15-20 trillion to the interest burden on the public debt, Mr. Kannan recalled. For the past two years, staff reports on Italy had emphasized the importance of privatization in the fiscal consolidation effort. It should be noted that, even taking into account the proceeds from privatization, the public debt was estimated to remain at close to 123.1 percent of GDP. Thus, more active consideration should be given to accelerating the privatization process.

Considering the importance of economic stabilization, the marginal decline in the fiscal deficit was welcome, Mr. Kannan stated. Nevertheless, the authorities should be encouraged to improve the efficiency of public finances, especially with respect to expenditures, by examining spending on a program-by-program basis, rather than across-the-board cuts.

Pension reform could make an important contribution in the effort to contain the fiscal deficit, as pension payments currently outweighed contributions, Mr. Kannan suggested. The current deficit of the pension plan emanated from the overly generous system that had been in place for the past 15 years. Therefore, in reforming the pension system, it would be important to carefully consider each category of pensions. Based on experience in other countries, the Italian authorities should also consider the introduction of private pension funds. However, the imposition of penalties on early retirement should be avoided, because such penalties could give rise to unnecessary social tension, and they represented only a temporary solution.

At the past two Article IV consultations with Italy, Directors had noted that the Bank of Italy was using monetary aggregates as well as some other economic indicators in its pursuit of anti-inflationary policies, Mr. Kannan remembered. He wondered why the Bank of Italy was now attaching less importance to monetary aggregates. One possible explanation would be that the disintermediation was a consequence of financial destabilization. However, in the current macroeconomic setting, there could be other factors at play. Considering the level of capital flows in equity markets and the highly concentrated banking sector, he wondered how many independent indicators were available for the Bank of Italy to use as guides for policy. It would seem appropriate to continue to use credit and monetary aggregates as indicators for monetary policy, in the absence of a nominal anchor. Although the 1993 depreciation had had only a minimal impact on price stability, the improvement in competitiveness in 1994--which was almost equal to the price increases--strongly indicated that any further depreciation of the lira would be fully reflected in domestic prices and, thus, should be avoided, particularly in light of the very bleak prospects for achieving the 1995 inflation target. As Mr. Lanciotti had indicated, the authorities should focus on improving productivity gains, which would alone pave the way for more durable improvements in the overall level of competitiveness.

The indication that, in 1994, almost one fifth of the banks were estimated to have incurred losses, owing to poor loan quality, was a serious cause for concern, Mr. Kannan considered. Clearly there was a need to further strengthen banking supervision and prudential regulation as a prerequisite for deeper reform of the financial sector.

Mr. Fernández noted that the staff report accurately described recent economic developments in Italy and correctly emphasized the key economic problems and policy dilemmas facing the authorities. It was to be hoped that the recent approval of the supplementary fiscal package would put in motion a virtuous circle of developments in the foreign exchange markets.

Although the strong prospects for an economic recovery had not been seriously damaged by political and financial uncertainties thus far, a continuation of those uncertainties could put the sustainability of the economic expansion at risk, Mr. Fernández considered. Therefore, the recent strengthening of the credibility of the authorities' fiscal consolidation effort was welcome. He agreed with the assessment of that effort contained in the supplement to the staff report. However, the medium-term strategy to stabilize the debt/GDP ratio was not sufficiently ambitious to accommodate Italy's desire to join the EMU in 1999, as stronger efforts than those currently envisaged clearly would be required to meet the Maastricht criteria.

The current turmoil in world financial markets was contributing to Italy's domestic economic problems, Mr. Fernández commented. Indeed, the inconsistencies in monetary and financial policies among the three major reserve currencies were making the effort to stabilize financial markets more difficult. They were also making the economic stabilization efforts of individual countries, like Italy, more troublesome.

Nevertheless, inflationary expectations in Italy were growing not only because of the weakness of the currency, but also because of the rapid increase in domestic demand, Mr. Fernández said. In that connection, additional revenues were needed to reduce the fiscal deficit.

However, increases in indirect taxation could have adverse effects on the effort to combat inflation, Mr. Fernández stated. As the staff had correctly pointed out, an inflationary spiral could develop if enterprises translated higher taxes into higher prices, or if trade unions translated higher prices into higher wages. Thus, there was a clear risk that higher indirect taxation could give rise to ex post indexation.

Although the wage negotiations at the national level would be based on the Government's forecasts of future inflation rates, wage negotiations by individual firms were expected to be based on increases in productivity. Considering the increases in productivity that were taking place in several sectors of the economy, relatively high wage increases could be expected, and they could have spillover effects on the rest of the economy, raising prices.

He wondered whether the staff could comment on the concept of "inflation net of indirect taxes" used by the Italian authorities, Mr. Fernández continued. Was that concept being used to try to measure a once and for all increase in prices? To what extent could that concept be used in analyzing the overall macroeconomic framework?

The staff projection for an annual inflation rate of 5.5 percent for 1995 seemed to imply that the impact of direct taxation on prices would amount to more than 1.5 percentage points, Mr. Fernández went on. Such a scenario would indicate the development of relatively high interest rates which, in turn, would suggest that the supplementary fiscal package was not sufficient to achieve the deficit target of 8 percent of GDP for 1995.

Moreover, the markets seemed to perceive the supplementary fiscal package as primarily an attempt to offset the deviations in the regional budgets at the end of 1994, and most of the measures contained in that package were of a one-off nature, Mr. Fernández added. Therefore, he wondered whether further corrective measures would be needed in 1995 to meet the target for the fiscal deficit.

In light of the continued lack of effective policy coordination among the major reserve currencies and the continued domestic political uncertainties in Italy, the value of the lira would likely remain weak, Mr. Fernández considered. In the circumstances, it was clear that the Bank of Italy was overwhelmed in its efforts to stabilize prices. As higher interest rates would likely exacerbate financial uncertainties and a devaluation of the lira would add to inflationary expectations, the only effective policy response would be to try to convince economic agents of the Government's willingness to take stronger fiscal adjustment measures.

He wondered whether the staff could comment on the extent to which comfort could be taken from the fact that 95 percent of the outstanding Italian debt was held by residents, Mr. Fernández said. Did the staff expect Italian savers to continue investing in public debt, so that the savings ratio in Italy would remain at the very high levels achieved in the recent past?

He also wondered whether the staff had conducted an analysis of the countries in the EU with very large stocks of debt, Mr. Fernández stated. For example, how did the staff expect holders of public debts to behave within the context of monetary union? What kind of refinancing policies were likely to be adopted by the treasuries of those countries, and what implications would those policies have for the real economy? Such an analysis would be helpful in considering the situation of members of the EU. It was to be hoped that such matters would be addressed in the context of the next Article IV consultation with Italy.

The Director of the European I Department recalled that the staff and the Italian authorities had been involved in ongoing discussions concerning an appropriate framework for the conduct of monetary policy since September 1992, when the lira had exited from the ERM and Italy had lost the exchange rate anchor. The Bank of Italy had taken a step toward greater transparency, as recommended by the staff, with the inclusion of a section on inflation in the most recent quarterly bulletin of the Bank of Italy; that section had, however, focused more on developments over the recent past than on likely future developments, and a desirable next step would be for a more forward-looking report.

At the present stage, the Bank of Italy, did not employ a clear set of operational guidelines in making decisions concerning interest rates, the Director said. In the absence of a more stable intermediate target, such as that provided by the exchange rate in the past, it was not clear how the central bank would respond to shocks affecting the financial markets. One of the main advantages of inflation targeting was that it would offer the monetary authorities a means to cast policies within a medium-term framework in a way that would send a clear signal to the markets that the central bank attached paramount importance to the rate of the inflation and that it was prepared to act in the event that inflation indicators pointed to a need for either monetary tightening or loosening. The case of the United Kingdom showed the advantages of maintaining a transparent framework for the conduct of monetary policy, especially through the issuance of inflation reports by the central bank.

In discussions with the Italian authorities, the question had arisen of how inflation targeting by the Bank of Italy would, in the current institutional framework, be related to the inflation targets contained in the Government's medium-term fiscal plan, the Director said. It should be noted that the inflation target of 2.5 percent in the 1995-97 program had never been intended as a guide for monetary policy, and there was no expectation that monetary policies would be geared toward the achievement of that target. Nevertheless, that inflation target had proved very useful as a focal point for incomes policy, which was based on an agreement by the Government, industry, and labor to base national wage contracts on targeted inflation rates. When the inflation target of 2.5 percent had been set in the fall of 1994, the trade unions had been fully aware that actual inflation was likely to be higher. Nevertheless, they had been willing to accept the target in the wage bargaining process, and the resulting likelihood of a decline in real wages, owing to the current high level of unemployment.

While the Bank of Italy was not prepared to challenge the Government's inflation target, as that could negatively affect the wage negotiations, it expected inflation to be closer to 3.5 percent in 1995, which would still represent some improvement over the inflation performance for 1994, the Director added.

There was likely to be more scope for inflation targeting in the future, however, as Italy's inflation rate declined toward levels prevailing in other countries in Europe. Incomes policy should not be a permanent feature of wage determination. This would make it more feasible for the central bank to announce and adhere to an inflation target.

Inflation targeting would work differently in Italy than in some other countries since the central bank was almost completely independent in terms of setting interest rates, the Director commented. Considering that the Bank of Italy did not have to negotiate with the Treasury or other parts of the government in order to adjust interest rates, it would be useful to make the framework for monetary policymaking more transparent in order to give the markets clear signals not only about the likely course of policies over the medium term, but also about the ways in which the Bank of Italy would respond in the event of shocks.

If the demand for money was sufficiently stable to provide a realistic indicator of monetary developments, the best course of action would be for the authorities to use a monetary aggregate as a guide for policies, the

Director considered. However, that was not the case. For example, in the summer of 1994, when financial market pressures had mounted, the indicators on credit and money demand had not pointed to the need for a tightening of policies. Indeed, many had criticized the Bank of Italy when it raised the discount rate by 1/2 of 1 percentage point in mid-August despite the slowing growth of money. Nevertheless, considering the inflation outlook for 1995 and 1996 and the recent exchange rate depreciation--coupled with the strengthening of domestic demand in Italy as well as in other countries in Europe--that move by the central bank was appropriate to forestall inflationary pressures and bring official interest rates into line with market rates. Similarly, the more recent move by the central bank to tighten monetary policy further, following the further depreciation of the exchange rate--which signaled renewed inflationary pressures--had sent a positive signal to the markets, despite its impact on the budget.

Given the extreme sensitivity of Italy's public finances to interest rate movements, there was a limit to how far the central bank could go in tightening monetary policies to combat inflation, the Director said. For example, in September 1992, when the Bank of Italy increased interest rates in an effort to protect the parity of the lira within the ERM, that action had had perverse effects owing to the fragility of the budget. In other countries, such as France, interest rate movements were reflected in the budget only with long time lags. However, in Italy, increases in interest rates almost immediately had a significant impact on the budget, owing to the relatively short average maturity of the debt and the large share of floating-rate debt.

Against that background, the extent to which monetary policies should be tightened was largely a matter of judgment that in the present policy setting had to be determined by the central bank on a case-by-case basis, the Director noted. Defining a medium-term framework for the conduct of monetary policies would thus help to enhance the central bank's ability to act. However, particularly given the impact of interest rates on the public finances, this would mean that a formal agreement would need to be reached between the central bank and the Government on a common inflation target. Under the current institutional framework in Italy, the central bank participated in the authorities' discussions concerning the Government's official inflation target, but that target did not have operational significance for the central bank in terms of its policymaking.

Although the 1995 financial law might have been sufficient for the conditions prevailing when it was formulated in the fall of 1994, a strengthening of the consolidation effort was clearly needed at the present stage, owing to the significant worsening of the outlook for interest rates, the Director considered. Given the size of the public debt, which amounted to about 120 percent of GDP, and its relatively short maturity, financial market developments could change the situation with respect to the public finances overnight. For example, the recent increases in interest rates had added as much as 1.2 percent of GDP to the interest burden on the public debt.

It should also be noted that, following the general election of March 1994, the long-term interest rate differential vis-à-vis Germany had been about 250 basis points, the Director said. However, in the wake of the economic and political events leading up to the collapse of the previous government in January 1995, that differential had risen to about 500 basis points, and it currently stood at about 650 basis points. If that trend continued, the situation could become critical, and beyond the scope of monetary policy to solve.

Indeed, even fiscal packages of the sort that could be approved by the current Parliament could not address such a crisis, the Director of the European I Department considered. Therefore, it was to be hoped that the political situation in Italy would be clarified, with assurances from all parties that the stabilization and adjustment effort would continue over the medium term. Ideally, economic policy and fiscal adjustment should be considered as a bipartisan issue, with the political parties indicating in advance that they were committed to addressing the problems facing the country.

Mr. Schoenberg commented that he agreed with the staff that the conditions were not right for an early re-entry of the lira into the ERM. However, the Bank of Italy could use the exchange rate, either as a single intermediate target or as one of several intermediate targets, as a guide for monetary policy. In the current conditions of waning investor confidence, the Bank of Italy clearly needed a higher degree of visible self-commitment than an inflation target could provide. To the extent that the Bank of Italy could not explain to the public how an inflation target of 2.5 percent could be met, such a target would remain tantamount to discretionary policy.

The Director of the European I Department said that the exchange rate played a large role in the Bank of Italy's decision making, as it was a determinant of the rate of inflation.

Based on the interest rate prevailing at end-December 1994, it should be possible to meet or even exceed the fiscal target for 1995, the Director stated. However, if interest rates continued at their current higher levels, there would be a need for further action.

In Italy, the authorities' three-year plan was revised and extended each year, the Director noted. The staff considered that it would be important to ensure that the deficit-reduction effort incorporated in that plan were kept in line with the goal of meeting the Maastricht criteria by 1998. While the current plan would result in a significant decline in the debt/GDP ratio as those criteria required, if interest rates returned to normal levels, this would not be achieved on current policies if interest rates continued at their current levels. In strengthening fiscal adjustment in the context of the authorities' medium-term strategy, it would be important to emphasize the expenditure side of the budget. The reform of the pension system could make an important contribution in that respect. There was also some room to increase indirect taxation.

In Italy's current circumstances, it would be difficult to accurately assess the equilibrium exchange rate, the Director commented. Nevertheless, based on its analysis, the staff agreed with the authorities that the current exchange rate was undervalued, as the depreciation of the currency had far more than compensated for the loss of competitiveness that had occurred prior to September 1992. In the staff's assessment, Italy was likely to experience a declining saving ratio in the future as a result of demographic trends, resulting in an equilibrium current account position, rather than the surpluses currently envisaged. As the projections, based on unchanged real exchange rates, indicated an external current account surplus of 2.5 percent of GDP or higher by 1998, it was clear that the exchange rate was not at equilibrium.

That was not to say that there were not valid reasons for the current level of the exchange rate, the Director of the European I Department said. However, the weakness of the lira was not attributable to competitiveness considerations so much as to concerns that there could be a resurgence of inflation if the fiscal adjustment effort were not completed. It was the task of policies to disprove the expectations underlying market valuations of the currency. The current exchange rate could at some point in the future become the equilibrium rate, but that would imply much higher rates of inflation in Italy than would be compatible with a return to the ERM.

Mr. Fernández commented that it was surprising to note the lack of attention that had been devoted to recent developments in international financial markets for the current discussion. It would seem that the weakness of the dollar and the lack of coordination among monetary policies in the United States, Germany, and Japan had played a role in recent developments in Italy. Indeed, those factors were likely to have important implications for economic developments in many countries.

The Director of the European I Department responded that, although developments in international financial markets had no doubt played a role, the staff had concentrated on factors specific to Italy. While many currencies had weakened over recent months, owing to the decline of the dollar vis-à-vis the deutsche mark, the Italian lira had fallen more than other currencies. Moreover, the lira had depreciated vis-à-vis the dollar. Therefore, the depreciation of the lira was not solely attributable to developments in the international financial markets.

The recent changes in the pattern of unemployment were attributable to a variety of factors, the Director noted. First, the reforms introduced under the new collective bargaining system had made it far easier for enterprises to fire workers. Second, the overall decline in employment in the public sector had reduced its ability to act as a buffer for declines in employment in other sectors. Third, the general trend toward rationalization had resulted in intense labor shedding in the services sector. In line with the economic upswing, recent indicators showed an increase in employment in the industrial sector, a sharp fall in the number of workers in the Wage Supplementation Fund, and a steady increase in the number of hours worked. Thus, the economic upswing could be expected to result in rising levels of employment over time. However, it should be noted that employment was not expected to increase in either the public sector or the services sector. Moreover, regional disparities would likely persist, given the relatively greater dependence on public sector employment in the south than in the north.

The privatization effort was also likely to affect employment, the Director continued. Indeed, that effort was already having some impact on the labor market, because the state-owned enterprises were no longer able to offer as generous terms of employment--or as many positions--as they had in the past.

The staff agreed with Directors that much bolder reforms were needed in the labor market, the Director went on. There was clearly a need to address the disparities among both regions and enterprises.

The rationalization process and labor shedding inspired by the new collective bargaining agreement could be expected to continue over the period ahead, the Director added. However, it should be noted that that agreement had made it easier for firms not only to fire workers, but also to hire new ones, because the costs associated with firing employees had been reduced. The net effect of the agreement would thus lead to an improvement in the flexibility of the labor market.

The household savings ratio in Italy was traditionally high compared with other countries, the Director said. There was no provision for deducting mortgage interest from income taxation, and until recent years only 50 percent of the purchase price of real estate could be financed by banks. Thus, there were strong incentives for people to save in order to purchase homes. The increasing age of the population had also contributed to the high level of savings, as most people sought to supplement their pension benefits with interest income.

Although the level of savings had fallen somewhat during the recession of 1993, it had increased over the past year in line with expectations, the Director stated. The decline in the savings rate projected to take place over time would place a constraint on the Government's ability to finance deficits. However, that constraint would be offset to some extent by the development of the Italian bond market, which was very efficient and made it difficult for others to compete with the Government for funds.

It should be noted that the liberalization of markets had resulted in a shift in portfolios away from Italian lira, the Director commented. Although data for the first quarter of 1995 were not yet available, recent indicators implied that there had been a decline in foreign portfolio investment, owing to uncertainties about the course of exchange rates.

There had also been some diversification in the portfolios of Italian bond holders. However, the Government had not encountered any difficulties in placing its bonds. Indeed, all of the Government's bond sales, including the most recent one, had been over-subscribed, albeit at very high interest rates. The current high level of interest rates was also constraining the Government's ability to issue bonds, especially bonds with long maturities that would tend to lock in high interest rates for some time.

The current Government was committed to the privatization effort not only for structural reasons, but also for fiscal ones, the Director of the European I Department noted. If the present Government were able to continue the privatization effort at the current pace, it could be expected to achieve, if not exceed, the target for privatization proceeds.

Mr. Autheman commented that in the current circumstances, which were fraught with political uncertainties and waning confidence, the markets were expecting an eventual increase in inflation rates. Therefore, it could be dangerous to advise the Bank of Italy to adopt firm targets for monetary policy, especially as such targets were not binding and there was a high probability that they would be missed. It would be wiser for the monetary authorities to rely on discretion than to take such a gamble.

The Director of the European I Department said that if the Bank of Italy had not focused on inflation, along with monetary aggregates, in its formulation of monetary policies, it would not have been able to justify the increase in interest rates in August 1994. Indeed, the Bank of Italy had specifically cited increasing inflationary pressures as the reason for that increase in its statements to the press.

Although the staff did not intend to suggest that the Bank of Italy should move immediately to announce the adoption of formal inflation targets, the staff considered that the authorities should begin to carefully consider the benefits of such an approach and begin to lay the groundwork for the adoption of clear targets. It should be noted that Italy had shadowed the narrow band of the ERM before it had entered the group of narrow band currencies.

Mr. Schoenberg remarked that the widening of the long-term interest rate differential vis-à-vis Germany clearly could not be taken as an indication of growing confidence in the current stance of monetary policy in Italy.

Mr. Shields said that, from the current discussion, it was clear that the staff had maintained frequent contacts with the Italian authorities over recent months. Although those contacts had resulted in improved debt management, he wondered how productive they had been with respect to the overall policy framework. As Italy was among the countries that warranted closer surveillance by the Fund, he wondered whether the Board should consider the case of Italy more frequently, or whether more frequent contacts between the Fund and the authorities at higher levels would be helpful.

The Acting Chairman stated that the case of Italy demonstrated both the strengths and weaknesses of Fund surveillance. It would be difficult to cite a case where there had been better contact between the staff and the authorities or a better exchange of information. However, the fundamental problems facing the Italian authorities could not be overcome by Fund surveillance alone.

The Director of the European I Department recalled that the staff had been working very closely with the Italian authorities over the past two-and-a-half years. The staff had visited Rome each year on the occasion of the presentation of the three-year plan as well as for the regular Article IV consultation discussions. On each of those occasions, the staff had conveyed its views to the authorities in writing on a confidential basis, although the authorities had at times made the staff's advice public. In that respect, the case of Italy could be seen more as an example of what could be accomplished with surveillance than as an example of how surveillance could be improved.

Mr. Wei made the following statement:

> The Italian economy has begun to recover in spite of political uncertainties. Surges in exports, a positive trade balance, and gains in productivity indicate that the recovery is gaining momentum. As the staff notes, the economic upswing is still in its early stages. The weakness in the lira reflects a lack of confidence in the authorities' capacity to tackle the fiscal imbalance, and poses a threat to controlling inflation and restoring confidence in the financial market, thereby undermining the prospect for growth. We agree with the staff that there appears an urgent need for fiscal consolidation and public debt reduction.
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> The current three-year fiscal consolidation plan, emphasizing expenditure restraint, has laid down a good framework for fiscal adjustment. However, political uncertainty and the lack of specific measures to control expenditure, as well as past experience, are causes for concern. The recent increase in interest rates by the Bank of Italy, a correct policy move to deal with inflationary expectations tied to the weakness of the lira, makes fiscal adjustment more imperative and challenging, requiring long-term structural measures to be brought into place.
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> We appreciate the authorities' supplementary fiscal package which includes measures to raise tax rates and cut spending, and we are pleased to learn that it was approved by Parliament yesterday. In addition to the firm adherence to implementing the announced fiscal adjustment measures, due attention should be

given to improving public finance management, such as expenditure management and tax administration, and also to the structural reduction in transfers to public sector entities and local and regional authorities. The serious problem of pension deficits must also be tackled.

Caution and vigilance has been shown in monetary policy since the departure from the exchange rate as an anchor. As mentioned above, the recent decision to raise interest rates is a right response to the less sanguine inflationary expectations. However, without significant improvement in fiscal policy credibility, monetary policy in the current situation seems rather limited. In this respect, we are encouraged by the monetary authorities decision to reduce inflation by controlling the money supply, as declared in Mr. Lanciotti's statement on "reducing inflation to the level required for convergence within the EU."

Nevertheless, the development of a clear monetary policy framework is critical for building credibility, and should not be delayed because of a lack of progress in fiscal consolidation. A strong and independent central bank should be the core of a formal monetary framework, thereby enhancing the transparency and accountability of monetary policy.

Although efforts to increase flexibility have been taken, a fundamental reform strategy is still lacking with regard to labor market structural rigidities. The current political situation may not permit the carrying out of such measures, but we encourage the authorities to give due consideration to this effort, as it is closely linked with structural fiscal imbalances.

Finally, while we appreciate Italy's financial assistance to developing countries, we note that Italy's expenditure on ODA in 1993 was reduced from the level of previous years. The authorities are encouraged to double their efforts toward meeting the UN objective.

In sum, although serious and daunting tasks remain to improve economic fundamentals and macroeconomic policy credibility, the outlook for the Italian economy as a whole is undoubtedly encouraging, providing the authorities with the opportunity to address serious fiscal imbalances.

Mr. Kang made the following statement:

I want to commend the staff for its well-balanced message to the authorities. The positive developments in Italy include a marked improvement in competitive position, wage moderation, progress in inflation, privatization, and--above anything else--an upswing of the real economy.

The main policy challenge remains the budget deficit and the associated level of government debt. I fully share the opinion of the staff on the scope for further spending curbs, in particular in pension expenditure, and further increases in revenue.

I want to touch on the tax reform area. In the era of reform competition, decentralization is becoming popular. I wonder whether it would be appropriate to seek a decentralization of the tax system in Italy at the present time. Considering the Central Government's huge role at present and in the future, and also considering the significant income difference between the north and south, a central tax administration system may well be preferable.

In a decentralized system, the Central Government may not find the resources needed to support areas in difficult circumstances and to provide the level of national infrastructure so important to the overall competitiveness of the economy. The increase in the tax powers of local authorities, particularly when the tax system changes, whatever the objectives--simplification or streamlining--means that there is a risk that actual collections may be much lower than expected. Here, once again, I agree with the staff's warning that a wide-ranging reform might have an adverse impact on revenue.

I want to emphasize the importance of the leadership of government. Somebody has to show willingness to give up some benefits to convince others to follow. Some reduction in government employment and wages may be a good method of consensus building.

I believe that many are interested in improving the budget decision-making process, as illustrated by Mr. Clark. The staff or Mr Lanciotti may have some comments to make on the possibility of such reforms being incorporated in the Italian Government and in the bureaucratic structure.

Mr. Barro Chambrier recalled that, at the previous Article IV consultation with Italy, Directors had commended the authorities for the wide range of measures that had been implemented in the fiscal, monetary, and structural areas, which promised to improve the efficiency of the Italian economy over the medium term.

It was encouraging to note the indications that the economic recovery was strengthening; that inflationary pressures were subsiding, owing to the wage agreement; and that the external current account was generating a surplus, Mr. Barro Chambrier said. However, those economic gains were being threatened by recent political developments, which created uncertainties about the pace of adjustment. Those uncertainties had affected the public finances and had contributed to an erosion of market confidence, as evidenced by the instability in the capital markets and the significant increase in the interest rate differential vis-à-vis Germany.

While it was also encouraging to note that some improvements had begun to take hold, in particular with respect to the shift in wage behavior, increased price stability, and a more open and competitive financial environment, serious challenges remained, especially with respect to the need for fiscal and structural adjustment, Mr. Barro Chambrier stated. Italy was standing at a crossroads, where those challenges would need to be addressed forcefully in order to better integrate its economy with the EU. In that respect, he shared the concerns expressed by previous speakers on the need to accelerate labor market reforms and to reduce regional disparities.

As he broadly agreed with previous speakers' comments on the direction of macroeconomic and structural policies required to address the challenges ahead, he could limit his intervention to some aspects of public finance and monetary policy, Mr. Barro Chambrier commented.

The recent improvement in economic conditions provided the authorities with an excellent opportunity to resume and even deepen the fiscal consolidation process, Mr. Barro Chambrier considered. Despite the current political constraints, the authorities should persevere in their efforts to gather a broad consensus in support of their medium-term objectives. The progress achieved by Italy thus far clearly showed the benefits of such an approach. As the staff noted, it was critical for the authorities to design and implement a credible program of fiscal adjustment, including measures aimed at reducing the public debt/GDP ratio. He welcomed Mr. Lanciotti's indication that the authorities were firmly committed to the fiscal consolidation effort, as evidenced by the supplementary fiscal package recently adopted by Parliament. Nevertheless, he agreed with other speakers that the authorities should stand ready to take additional measures to ensure a permanent improvement in the fiscal accounts.

The monetary authorities should not overlook the impact of the worsened outlook for interest rates on the budget, Mr. Barro Chambrier said. In order to ensure the sustainability of the economic recovery, it would be essential to persevere with prudent monetary policies. It was important to note that the absence of a credible fiscal adjustment program placed an extra burden on monetary policy. Although the depreciation of the lira might have given Italy a competitive advantage, it could also place upward pressure on domestic prices. Therefore, Italy should immediately embark on a strong medium-term program of macroeconomic stabilization. Progress toward economic stabilization would also help to ensure the achievement of growth objectives and, thus, help to reduce the level of unemployment.

He wondered whether the size of the informal sector in Italy tended to overstate the magnitude of the unemployment problem and to understate the amount of economic activity.

He commended the Italian authorities for their continued assistance to developing countries. Italy should be encouraged to increase the level of its official development assistance to the internationally agreed target, as its financial situation improved.

Mr. Shaalan made the following statement:

Despite the political uncertainties and the persistence of tensions in financial markets that have characterized the Italian economy in 1994, it is commendable that the recovery that began toward the end of 1993 continued to pick-up momentum--with GDP growth for the past year now estimated at 2.5 percent, inflation falling to a record low of 3.9 percent, and the balance of payments in near balance.

Nevertheless, as noted by previous speakers, the ongoing recovery remains fragile, largely as a result of the reluctance to proceed with strong fiscal consolidation last year, for fear of jeopardizing the recovery. Unfortunately, as noted by the Board in the last Article IV discussion, the consequent erosion of market confidence in the Government's commitment to achieve a sustainable turnaround in public finances led to a continued weakness of the lira, higher interest rates, and a clouding of the medium-term outlook.

The supplementary budget passed by Parliament yesterday, containing additional fiscal measures that would improve the 1995 fiscal deficit target by about 0.5 percent of GDP to 7.5 percent, is therefore a welcome step. As a result, the stabilization of the debt/GDP ratio is now projected to materialize in 1995 instead of 1996. It is also pleasing to note that, in contrast with the bulk of the revenue measures contained in the original budget, most of the additional measures in the minibudget are of a permanent nature.

However, it must be noted that the uncertainties in the original budget remain, particularly those regarding the estimated yields of the new tax assessment procedures for certain taxpayers and the amnesty on illegal construction. With regard to the latter, I am concerned about the likely negative long-term effects on tax compliance of the repeated use of tax amnesty to bolster revenues.

Beyond 1995, I have three concerns with regard to the fiscal adjustment plan for 1996-97. First, it is not sufficiently ambitious, undermining the authorities' commitment to the 1998 Maastricht targets. The authorities should use the expected yield of the permanent measures contained in the supplementary 1995 budget to strengthen the fiscal adjustment planned for 1996-97. Second, it lacks specific measures of expenditure restraint through which the bulk of the projected adjustment is to be effected. Third, as indicated by the staff's medium-term scenario, the high sensitivity of the fiscal consolidation outcome to variations in interest rate levels casts considerable doubt as to the attainability of the authorities' announced objectives. As demonstrated in 1995, the targeted improvements in the primary balance risk being swamped by higher than projected interest rates, with a real possibility that the debt/GDP ratio proceeds on a rising, rather than declining, path beyond 1998.

Therefore, I would urge the authorities to adopt more ambitious targets for the 1996-98 medium-term fiscal plan and--to ensure the plan's credibility--the adjustment should be more front-loaded and should include the two key structural measures, namely, pension and tax reform. Acceleration of the pace of privatization, as indicated in Mr. Lanciotti's opening statement, is also an important component. The adjustment should also include measures aimed at reducing the Government's wage bill and transfers to public sector entities, as well as public expenditure management reform.

However, I would urge the use of caution with respect to the tax reform. Given the vulnerability of the budget at this stage, and the risks of substantial revenue loss with the planned shift from direct to indirect taxes, this move should be approached with extreme caution.

In light of the acceleration of inflation in February and the recent exchange rate weakness, as a result of both domestic uncertainties and more widespread financial market tensions, the Bank of Italy's most recent official interest rate increase was a prudent move. The course of monetary policy in the immediate future will no doubt continue to be affected by both domestic factors and developments in international financial markets. However, the adoption of a strengthened and binding medium-term fiscal adjustment program, provided it enjoys broad-based political support, should contribute significantly to resolving the present credibility crisis, and should reduce the need to tighten monetary policy further. I had hoped that yesterday's passage of the supplementary package in Parliament would have elicited a more positive response from financial markets. Unfortunately, today's initial weakening of the lira may be an indication of both the persistence of public skepticism and the fact that bolder action reflecting a sustainable commitment to fiscal adjustment in the longer term is needed.

I would also caution here that, in view of the high sensitivity of public finances to interest rate changes, the cost of raising official interest rates alone in the short term in response to a further weakening of the lira would outweigh the benefits in terms of inflation containment. However, particularly as the inflation outlook has worsened recently, I also hasten to add a word of caution against any premature easing of monetary conditions in the future, until there is solid evidence of a restoration of confidence and a significant strengthening of the exchange rate.

Mr. Dlamini said that the staff report clearly outlined the need for actions aimed at ensuring macroeconomic stabilization and sustainable levels of growth. Some important policy initiatives had been taken, including the abolition of wage indexation, the liberalization of the financial system, the increased independence of the Bank of Italy, and the efforts to cut expenditures. Nevertheless, he agreed with the staff that the medium-term plan was not sufficient to address Italy's fiscal problems. It seemed that the authorities would have difficulty meeting the Maastricht criteria by 1999.

While the unstable political environment clearly constrained the authorities' ability to rein in the budget deficit, the gains achieved in the real economy thus far could be jeopardized unless timely action was taken to bring about a more rapid reduction in the fiscal deficit, Mr. Dlamini stated. In that connection, he welcomed the recent approval by Parliament of the supplementary fiscal package which, together with privatization receipts, would further reduce the deficit and stabilize the debt/GDP ratio in 1995. One important feature of the supplementary fiscal package was its reliance on permanent measures. However, it could be seen as only a first step.

According to recent press reports, the lira had depreciated to an historically low level, despite the approval of the supplementary fiscal package, Mr. Dlamini noted. That could be seen as an indication that there were still serious uncertainties concerning the credibility of the fiscal consolidation effort. Therefore, the authorities should quickly proceed with the reform of the pension system, which--with payments equivalent to 15 percent of GDP in 1992--was among the most generous in Europe. Priority should also be given to rationalizing the budgetary process in order to ensure effective control over expenditures.

As many previous speakers had noted, the high level of unemployment remained a serious cause for concern, Mr. Dlamini commented. He agreed with the staff on the need for labor market reforms, including measures aimed at increasing labor mobility and simplifying the regulatory framework. Nevertheless, he wondered whether such measures would be sufficient to address the problem in the south, where the level of unemployment was near 20 percent. He shared the concerns expressed by previous speakers about whether the sale of state-owned enterprises would add to the problem of unemployment. The relatively lower level of economic development and the higher level of poverty in the south was a problem that would need to be addressed over the medium term and beyond.

He joined Mr. Barro Chambrier in commending the authorities for Italy's assistance to developing countries, Mr. Dlamini said. However, he would urge them to increase the level of Italy's official development assistance toward the internationally agreed target.

Mr. Daïri made the following statement:

I agree with the thrust of the staff appraisal and wish to make some brief comments. The recent economic recovery, price and wage moderation, and the strengthened external position are encouraging. However, the fiscal and debt situation remains worrisome and undermines confidence. I welcome the recent tightening of the fiscal position, but I join other Directors in urging the authorities to strengthen their fiscal policy in a medium-term perspective and to speed up the reform of the pension system. Clearer and more ambitious medium-term fiscal commitments and greater compliance with the targets at an early stage would reduce market uncertainties. This is, at the same time, more difficult and more urgent in the context of political instability.

With respect to monetary policy, I agree with other Directors that a more explicit inflation targeting by the central bank would help to reduce speculation and enhance confidence. I understand that the authorities consider that this targeting could be harmful if it were not supported by tighter and more credible fiscal targets. While I understand the authorities' concern, I feel that such a targeting would give a signal of an independent monetary policy that would help the confidence-building process. An orderly and appropriately timed re-entry into the ERM would strengthen this signaling effect.

As to labor market policy, a number of encouraging steps taken by the new Government are expected to alleviate overall unemployment. These initiatives do not, however, seem to appropriately address the rigidities inherent to the Italian labor market. As the staff has pointed out, a more comprehensive reform is needed to reduce restrictions and distortions in this market. Moreover, I did not find, and perhaps missed, any attempts aimed at reducing regional unemployment disparities that may explain some of the political instability. A persistent unemployment of about 20 percent in the south requires more targeted efforts, as indicated by Mr. Dlamini.

With respect to structural reform, the pace of privatization has lost momentum recently after good progress made in 1993 and in early 1994. I welcome the authorities' intention to accelerate the process in 1995. A positive point in Italian privatization is the fact that the resulting proceeds are being directed toward reducing the stock of public debt, a practice that the authorities are encouraged to continue.

Mr. Al-Jasser made the following statement:

Economic developments in Italy since the last Article IV consultation have been disappointing. Favorable growth performance placed Italy in a particularly propitious position to embark on long-overdue adjustment efforts. Unfortunately, domestic developments precluded the possibility of adjustment.

Against this background, the recent supplementary budget for 1995 is particularly welcome. The budget builds upon the measures envisaged in the original 1995 budget, which were considered as an indispensable minimum by the staff. Equally important, the supplementary budget will enable the stabilization of the debt/GDP ratio this year.

The permanent nature of the measures in the supplementary budget will also facilitate the task of formulating the budget for 1996 and the next three-year plan. In this regard, I particularly welcome the intention to bring the discussion of the 1996 budget forward. The early announcement of durable measures will facilitate the task of consolidation indirectly, by enhancing credibility and reducing market tension and the risk premium paid on government debt.

Having said this, one could question the efficiency of some of the revenue measures incorporated in the supplementary budget, in particular, the rises in some tax rates, including corporate income and energy taxes. A re-evaluation of these measures, in the context of the planned tax reforms, would be appropriate.

Reforming the tax system in Italy would be a welcome step. Reducing the complexity of the system and rationalizing tax rates may reduce incentives for tax evasion. Moreover, in view of the significant size of the grey economy in Italy, heavier reliance on taxes that are difficult to avoid will enable the Government to tap an important source of revenue that has long escaped taxation. Thus, I am less concerned than the staff about the risks of revenue shortfalls in the context of the tax reform.

Given an expenditure/GDP ratio of about 40 percent, budgetary consolidation in Italy should rely more heavily on expenditure measures. Here, I welcome the authorities' indication that the composition of the supplementary budget should not be seen as a shift away from the required emphasis on expenditure reduction. I also welcome Mr. Lanciotti's indication that the draft legislation for reforming the pension system will be presented by the end of March.

The conduct of monetary policy in the current circumstances raises some interesting issues. Italy's performance on the inflation front since its exit from the ERM has been impressive. But this performance is due, in part, to the recession and wage moderation. The challenge facing the authorities at this juncture is to contain inflationary pressure emanating from the recovery and the depreciation of the lira.

The establishment of the independence of the Bank of Italy was an important step in enhancing the Bank's effectiveness in achieving the objective. Moreover, Italy's cooperative approach in setting an inflation objective should enhance the credibility of this objective and facilitate the tasks of both the fiscal and monetary authorities in maintaining macroeconomic stability. On its part, the Bank of Italy must establish a clear track record, and be ready to take without hesitancy the necessary measures to achieve the inflation objective. In this regard, tracking a set of indicators appears to be the most appropriate course of action. This is especially the case as monetary aggregates in Italy have not shown the stability required to enable targeting a particular aggregate with sufficient confidence. Such instability can be expected to continue with further changes in the structure of the financial sector.

Structural policies have a critical role to play in Italy's adjustment efforts. I have little to add to the staff's recommendations in this area. Suffice it to note that adherence to the new privatization timetable is a necessary precondition for enhancing credibility in the authorities' overall policy implementation and for the reduction of the country's debt burden.

Mr. Justiniano made the following statement:

Italy has made progress over the past year in terms of growth, inflation, and external competitiveness. Despite the gains in these fronts, the extreme vulnerability of the current situation is highlighted by political uncertainty, a high Central Government overall deficit, a public debt/GDP ratio in excess of 123 percent, and the large concentration of public debt maturing in 1995.

At this stage, allow me a few brief comments for emphasis. I welcome the recent decision of the new Government to take additional corrective measures with a supplementary budget to safeguard the overall budget target and to stabilize the debt/GDP ratio in 1995 instead of 1996. Its approval yesterday by the Chamber of Deputies attenuates the uncertainty, which has seriously hampered the Italian economy in recent months.

Nonetheless, while this supplementary budget is a necessary condition for fiscal consolidation, a more stable political environment and deeper structural reforms will be needed to make a lasting improvement the public finances and to contain the mounting public debt. The staff's sobering medium-term scenario indicates that, even assuming a stronger recovery, the debt/GDP ratio would only decrease to 117 percent by the end of the century. In this context, it is difficult to disagree with the assessment that the deficit and debt dynamics are on a highly unfavorable path. A sound and sustainable fiscal position should therefore remain the fundamental goal of the authorities over the medium-term. The opportunity for greater revenue enhancement provided by the strong economic recovery should not be wasted.

As to inflationary expectations, the current weakness of the exchange rate--in spite of the rise in interest rates--and the increase in indirect taxes generate concern in this regard, with the consequent impact on negotiated wages. Moreover, current long-term interest differentials vis-à-vis Germany also indicate that financial markets still fear a pick up in inflation. I urge the authorities to persist with their wage moderation policy to avoid more inflation. Furthermore, although I am convinced that the Bank of Italy is committed to fighting inflationary pressures, like the staff, I wonder whether the new forecast of 5 percent for the cost of living does not justify a more anti-inflationary stance. In addition, greater coordination between both monetary and fiscal policy is needed to curb the market expectations of further increases in interest rates.

In the fiscal structural area, tax reform should be implemented to enhance the efficiency of tax administration, widen the tax base, improve collection, and reduce evasion. I wonder, however, whether this reform is on the immediate agenda of the authorities. I would appreciate comments from the staff in this respect.

Regarding pension reform, which I view as the main structural issue in Italy, it is worth noting that pension outlays are the highest among the Group of Seven countries, and one of the highest in the OECD. As noted by Mrs. Lissakers, the agreement with the trade unions recognizing that individuals' pension benefits must be linked to their lifetime contributions and be based on life expectancy sets the basis for the comprehensive approach that is needed. In this regard, I welcome Mr. Lanciotti's announcement that draft legislation will be presented by end-March and encourage its prompt enactment by the Parliament.

The authorities should also be commended for their recent decision to speed up privatization and complete the divestiture of insurance, finance, and electricity concerns by the end of July 1995. Further reducing the role of government in the economy can exert distinct benefit, as was the case in countries of this constituency, in terms of greater efficiency, lower fiscal expenditure, and less political influence in commercial decisions. It is to be hoped that parliamentary delays will not hamper the reinvigorated privatization drive.

As in other countries, greater labor market flexibility is needed in order to encourage faster job creations. In this respect, I would be interested in knowing the status of the draft legislation submitted to Parliament last August to facilitate temporary and part-time employment.

Finally, with respect to official development assistance, this chair recognizes the continued effort being made despite the adverse fiscal situation. It is to be hoped, however, that Italy's contribution to official development assistance will not be further reduced, in view of the significant decline since 1998.

The Director of the European I Department noted that one of the main problems with respect to the current tax system was that the local governments had authority to control spending, but they were not publicly accountable for raising the required tax revenues. The planned move toward greater fiscal federalism provided for transfers from the Central Government to compensate for regional disparities in income levels and tax revenues as well as to help finance structural improvements in the regions. The decrease in overall transfers would impose greater financial discipline on the local authorities.

The section of the background paper on the budget reform was a summary of a report made by a Fiscal Affairs mission, the Director said. However, the government with which that report had been discussed had since left office and the staff had not been able to take it up for consideration with the new authorities. Nevertheless, the staff expected that, once the political situation in Italy became more stable, action would be taken to reform the budgetary process.

Although the informal sector in Italy was relatively large, there was no official means of measuring activity in that sector, nor any indication of how it had changed much over time, the Director noted. The size of the informal sector might lead to an underestimation of the overall level of economic activity.

The level of unemployment in the south had been sustained over time by its dependence on public employment, official transfers, and other forms of direct and indirect subsidies, the Director of the European I Department said. As it was no longer possible to subsidize the south to the same extent as in the past, the level of unemployment in that area was rising. There was clearly a need to address regional disparities through a greater liberalization of the labor market and greater wage differentiation based on productivity. Previous attempts to reform the labor market had been met by strong opposition. However, the new wage pact provided for a second tier of bargaining at the enterprise level based on productivity and profitability.

It was to be hoped that those second-tier negotiations would lead to greater wage differentiation among regions over time. At the present stage, there was little or no incentive for investment to move from the north to the south. Public sector wages were the same in both areas; there was a shortage of civil servants in the north and an overabundance in the south.

Mr. Lanciotti made the following concluding statement:

Let me first commend the staff for its remarkable effort devoted to the skillful analysis and a reasoned description of the Italian economic situation. I would also like to thank Directors for a comprehensive and stimulating discussion. I am confident that my Italian authorities will carefully consider and make the best use of the opinions and recommendations expressed by Directors.

As the staff fully covered the questions raised by the Board, I would only like take up two points raised in the discussion and to share a few considerations with you.

On the first issue, I would like to prevent misunderstanding by the Board. I refer to the term structure of public debt and to the percentage thereof falling due this year. It has been a long-standing policy of the Italian Treasury to manage the debt in such a way as to lengthen its average life, which is presently 4.5 years.

The ratio of medium- and long-term bonds to the total increased from 23 percent in 1980 to more than 50 percent in 1994. The amount of debt falling due this year is not, as has been mentioned, over one half of the total, but rather well below one third.

The second issue that I would like to touch upon is the setting of the inflation target. This is complicated in Italy by the fact that official inflation targets are already announced and incorporated in the Government's three-year fiscal plan presented to Parliament in June of each year. As an excellent forthcoming staff paper on an inflation targeting framework for Italy (PPAA/95/4, 3/5/95) points out, the issue arises as to how the Government's official inflation target would be related to the Bank of Italy's inflation target. The paper offers a series of theoretical possibilities. In the present situation, however, it should be stressed that the objectives of monetary policy are set consistent with the inflation target established by the Government.

Indeed, as I have already indicated in my statement, the Bank of Italy looks at a number of indicators, paying attention to monetary as well as credit aggregates. As a matter of fact, an attempt is usually made to monitor the flow of funds consistent with real growth, balance of payment prospects, and the announced inflation and budgetary targets. Inflation developments, and its possible determinants, are kept under close scrutiny and are regularly discussed in the Bank's official publications.

In conclusion, even if the Bank of Italy does not explicitly participate in defining the Government's inflation target, in the current institutional setting, the safeguard of saving and the connected quest for monetary stability are certainly basic principles that motivate the Bank's policy and its determined anti-inflationary commitment.

Today's discussion shows a broad convergence of views among the Board, the staff, and my authorities about the most urgent actions that need to be promptly implemented.

There is a wide and increasing consensus in Italy about the need for a positive conclusion to the renovation process that the country has courageously undertaken in the past few years. It is a process that involves the institutions and their relationships with one another as well as with the civil society.

Reinforcing the connection between the institutions and the citizens, which is crucial for a lasting transformation of the country, implies the setting of clear ethical and efficiency criteria in public management. This also involves redefining the dividing line between the area of private activity that requires public intervention. The process of renewal requires finding sufficient political support in order to continue and increase progress toward fiscal consolidation.

Today, there is widespread awareness of the paramount importance of such an objective. Given its impact on income distribution, it nonetheless creates conflicts, tensions, and disagreement about the direction and the speed of the process. The exceptional size of the public debt held in private portfolios is such that political uncertainties and conflicts immediately affect financial market sentiment, thereby leading to interest rate rises and currency depreciation.

My authorities are committed to fostering the process of change within a framework of institutional stability and market confidence. The approval by the Italian Parliament of the supplementary fiscal package introduced by the present Government is a favorable outcome, which creates the necessary premise for continued progress toward the restoration of sound public finances. This, together with the reform of the pension system currently in preparation, will help improve market expectations, reducing the interest rate differential on government securities between Italy and other countries, thereby favoring a more appropriate exchange rate for the lira.

In the present situation, in which expectations are characterized by high volatility, the central bank is paying particular attention to any early indicators of price pressures. The recent further tightening of the long-standing restrictive monetary policy stance was designed to counter this tendency, and the Bank of Italy is determined to prevent a resurgence of inflation.

Continued consensus on incomes policy, which has become an established feature as a result of almost three years of responsible adherence to the guiding principles of the agreements and their rules of operation by employers and trade unions, is making a fundamental contribution to price stability. The central bank's resolute anti-inflationary stance is helping to ensure that the agreements are kept. The supplementary budget measures play their part in dampening inflationary expectations; they bring a desirable slowdown in the growth of domestic demand by impinging primarily on consumption, both private and public.

The recent acceleration in consumer price inflation, net of the indirect taxation effect, must first be halted and then reversed. The annual rate of increase in prices in 1995 may still be lower than that of last year, so that the downward trend under way since 1990 should not be interrupted.

The size of the slowdown will depend on market confidence, especially the foreign exchange market. If the foreign exchange markets recognize the favorable trend in public finance and, accordingly, restore the external value of the lira at least to the level of five months ago, this year's annual inflation rate could be lower than last year's, account being taken of the one-time effect of tax increases.

The Acting Chairman made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They noted that, over the past year, positive macroeconomic developments had been overshadowed by the looming threat of a confidence crisis, evidenced by financial market anxieties.

The country was now at a crossroads, and Directors stressed that the economic recovery presented the opportunity to begin to escape the long-standing fiscal predicament and initiate a reversal of the debt dynamics. In these circumstances, the central policy priority was to restore confidence by making rapid and durable progress in fiscal consolidation. Indeed, several speakers emphasized that Italy needed a binding and ambitious medium-term fiscal framework. Otherwise, persistent financial market tensions threatened a vicious circle in which inflationary pressures would increase and the recovery could be smothered.

With these contrasting prospects in view, Directors welcomed the important step that had been taken toward fiscal consolidation with the Government's corrective budget package. They noted that this package was aimed not only at safeguarding the 1995 fiscal targets, which were judged to be an indispensable minimum, but also at going further, making it possible to stabilize the public debt as a share of GDP beginning in 1995, as recommended by the Board at the previous discussion on Italy. Directors welcomed the inclusion in the package of permanent measures aimed at putting the debt-to-GDP ratio on a clearly declining path. This was a welcome shift from the heavy reliance in the 1995 budget on one-off measures of uncertain yield.

Directors noted, however, the uncertainties that still clouded Italy's prospects. The dire state of public finances, the history of continued fiscal slippages, and the current political turmoil were such that the desired confidence effects on the exchange rate and interest rate risk premia from recent positive policy moves had not materialized. On the contrary, financial market pressures had persisted, endangering the fiscal targets.

Against this background, Directors stressed the need to avoid slippages from the current corrective package and to follow that package up with further action to tackle long-standing expenditure rigidities. Directors strongly supported the Government's priority to implement a major structural reform of Italy's overly generous public pension system, which is needed to ensure the system's solvency and avert a growing burden on the public finances. They also welcomed the Government's intention to advance the timetable for the preparation of the 1996 budget, along with that of the new three-year plan. In that context, Directors believed that the current medium-term fiscal plan was not ambitious enough. They stressed that the opportunity should be seized to accelerate fiscal consolidation, setting targets that would be consistent with the requirements of participation in the process of European integration. Targets should be based on cautious economic assumptions, such as those concerning interest rates.

Directors also stressed the importance of continued careful attention to debt management issues in a country with such a large public debt and at a time of heavy financing requirements. While Italy's public debt was largely held internally, some Directors cautioned against being overly confident about the willingness of the Italian public to continue holding that debt, particularly in light of the financial liberalization and the possibilities of international diversification. A number of speakers also warned against relying on the continuation of Italy's relatively high level of private saving in the years ahead.

Directors observed that the ambitious inflation target set for 1995 was now regrettably beyond reach. They expressed grave concerns about the risk of a resurgence of inflation, stemming mainly from the persistent weakness of the lira. This, in turn, reflected the market's lingering skepticism about the prospects for sustained fiscal adjustment, and Directors thus viewed rapid and visible progress on the fiscal front as essential to forestall an inflationary upsurge. Such an upsurge, several Directors noted, could also put at risk the continued observance of wage restraint that had played such an important role in containing inflation in 1993 and 1994.

Directors stressed the critical role monetary policy needed to play in achieving and preserving price stability. While several Directors expressed reservations about formal inflation targeting in Italy's circumstances, there was general agreement that, with the lira outside the ERM, the monetary authorities needed to help anchor expectations by building credibility for their commitment to price stability. Many speakers welcomed the authorities' forward-looking approach to policymaking, with several Directors stressing the importance of its pursuit over the medium term, with the goal of price stability clearly in view, and encouraging the authorities in their intention to enhance policy transparency. Some Directors noted that recent developments highlighted the importance of conducting monetary policy within a formal monetary framework with inflation at its core. Several Directors emphasized the interactions between a formal monetary framework, the fiscal framework, and the system of wage setting.

Directors noted that a strengthening of the exchange rate of the lira would support disinflation without putting undue pressure on the external accounts. They viewed the current depreciated level of the lira as related mainly to fiscal and political concerns, however, and agreed that the authorities should not try to engineer an appreciation through monetary policy. In these circumstances, ERM re-entry was not seen to be currently a viable option.

Directors pointed out the importance of key structural reforms that would enhance the flexibility and efficiency of the economy and increase the employment content of growth. They noted that unemployment had remained high even as the economy was recovering, with the situation in the south being of particular concern. They welcomed steps already taken to improve labor market flexibility, but called for a bolder and more comprehensive approach to reducing hiring and firing costs, reforming the unemployment benefits system further, and promoting greater mobility and wage differentiation in the public sector. Directors also welcomed the acceleration of privatization plans, but cautioned that observing this schedule needed to be consistent with ensuring the program's long-term efficiency goals.

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

After adjourning at 1:00 p.m., the meeting reconvened at 2:30 p.m.

3. INTERIM COMMITTEE'S MADRID DECLARATION - IMPLEMENTATION OF ECONOMIC POLICY OBJECTIVES - PRELIMINARY REVIEW

The Executive Directors considered a staff paper on the preliminary review of the implementation of the economic policy objectives set out in the Interim Committee's Madrid Declaration (EBS/95/24, 2/28/95).

Mr. Clark made the following statement:

Before I comment on the substance of this review, I wish to compliment the staff on the format of the one-page summary appraisals of the selected countries' economic and structural policy programs. These summaries are helpful snapshots, although they, of course, cannot provide the whole story.

The substantive question is whether or not member countries have retained or adopted policies since the end of October that are consistent with the Madrid Declaration, or at least announced their credible intention to do so. Underlying the Declaration are the propositions that: market-based economic systems outperform administered allocation systems--a proposition with strong empirical support; integrated markets, which require liberalization of trade and capital flows and cooperation among international economic institutions such as the Fund and the World Trade Organization, perform more efficiently than fragmented markets; and, macroeconomic stability is necessary to achieve maximum gains from market-based economies.

The staff report is basically a report card on the country groupings identified in the Declaration--the industrial countries, the developing economies, and the transition economies. The grade given by the staff on the efforts of these country groups is, in aggregate, only about average. While we agree with this grade, we also note that there are exceptional individual efforts in each grouping. They are balanced, however, by some lackluster performances. This progress report can be viewed as a wake-up call for members to assess their own performance in the context of their Madrid commitments. Unfortunately, it may not be as effective a call as it could be for several reasons.

The time frame for such a retrospective evaluation is extremely short. Only six months have passed since the Madrid Declaration, which we know from our own Board experience, is often insufficient to build the necessary domestic consensus to adopt fundamental and workable policy changes. The report notes this problem, but does not consider what progress would be reasonable within such a short time period.

The tone of the report is, on balance, negative. It correctly identifies generally what still needs to be done, but leaves the impression that more should have been accomplished in the past six months. In fact, the tone of the main text leaves a less-balanced impression of the progress in some countries, Italy and China to name only two, than does the individual country summary. A more forward-looking and proactive message is that, despite a slow start, there is still time to move ahead on the Madrid commitments. Such framing of the message could provide a more positive role for the report in the reform process.

The pace of policy reform associated with the Madrid Declaration varies substantially across countries, especially for countries grouped as developing economies and as transition economies. To some extent, this reflects the difference in the initial degree to which the various economies are market based. For example, some of the transition economies have a history of market-based economies and have the capacity to re-establish markets quickly; others do not have this advantage. Because of the diversity in the broad groupings, it may be more helpful to classify developing and transition economies more finely for future analysis. The classification could be based on comparative disadvantages so that the countries that face similar policy challenges are grouped together.

As a group, the industrial countries have the most advanced market systems and are most politically dedicated to the preservation of these systems. The challenge for the industrial countries is to keep their economies growing while achieving high employment and low inflation. The main strategies for accomplishing these goals are, first, fiscal consolidation to increase domestic saving and private investment and, second, structural reform, especially to increase the allocative efficiency and skill content of labor markets.

The staff report suggests that progress in terms of structural reform has been reasonable for the industrial countries but that, so far, announced programs for medium-term fiscal consolidation have been generally unambitious, particularly for the large industrial countries. Although Canada is listed among this group, it has taken positive steps in its recent federal budget to address fiscal imbalances. More generally, the tensions in industrial countries between the need for increased social investment to retrain young unemployed workers and to sustain an aging population, and the need for fiscal restraint to raise potential output growth will take some time to work through. Nevertheless, we agree with the staff that they must be addressed soon in order to minimize the adjustment costs by taking full advantage of the global economic expansion.

The developing countries generally have some of the key elements of a market economy in place, but the developmental stages of the market infrastructures vary considerably across countries and are generally fragile in all countries. The challenges for these countries are to press ahead with reforms that will strengthen market infrastructures, to eliminate barriers to market development, to engage in social investment programs to raise resource productivity, and to implement effective macroeconomic stabilization policies.

The staff's assessment of progress for developing economies varies considerably from country to country. The overall impression, created by the focus on failures of particular countries to meet specific challenges, is that performance has been disappointing, especially in terms of macroeconomic stabilization policy. This is clearly true for some countries. Many developing countries that embraced trade liberalization and financial sector reform have been slow to adopt suitable macroeconomic stabilization policies. However, progress has been substantial in other cases, and one hopes that these will encourage others to initiate comparable policies. For example, Argentina's recently announced policy reforms are impressive.

The staff's best grades seem to go to the transition economies. Even though there is still a long road ahead, some of the necessary reforms in the public sector, the government enterprise sector, and the financial sector are under way. However, market-oriented reforms will not yield maximum performance--especially in the former Soviet Union economies--until the legal and institutional structure--such as, property rights, credit rights and obligations, and bankruptcy laws--that guide market behavior are better established. Also necessary are more stringent and consistent macroeconomic stabilization policies, which will allow markets to develop credibly as devices for allocating resources in a timely and efficient manner.

Based on the staff's analysis, the failure with respect to the Madrid Declaration most common to all countries is the failure to announce and implement necessary macroeconomic stabilization policies. One must hope that this is merely a temporary failure, as members are already aware--or are quickly becoming so in the light of recent international developments--that stability in highly integrated, market-based, economic systems depends critically on macroeconomic stability in individual countries.

Mr. Bergo made the following statement:

The Madrid Declaration as a formal commitment to follow sound economic policies represents a welcome step toward stronger collective discipline on economic policies by the world's economies. How significant a contribution this will be, will, however, depend very much on the conscientious implementation of prescribed policies and of the effectiveness of the surveillance and the follow-up mechanism.

The fact that a community of 179 countries can come to a common view on the basic parameters of their mutual responsibility in terms of economic policies is remarkable in itself. By the same token, it is not surprising that the prescribed policies are cast in rather general terms. In my view, for the surveillance to be as effective as possible, the Fund will have to, starting from the common view embedded in the Madrid Declaration, develop more tangible criteria of performance. I fully recognize the difficulty of this, but, without it, the contribution to enhancing surveillance will be less.

The survey prepared by the staff for this meeting is a good starting point. I appreciate the frankness and clear language that characterizes most of the document, including the country assessments. However, the link between the objectives set forward in the Madrid Declaration and the individual country summaries could be strengthened further. I note that the staff observes that, among industrial countries, only Germany and United Kingdom seem to satisfy the requirements of the Madrid Declaration with regard to fiscal consolidation. Even if there are some indications of which countries are considered furthest from the requirements, it might be conducive to the discussion if the staff would dare to stick its neck somewhat further out. For instance, one may ask what would be required for fiscal consolidation in the United States, and in what time perspective, to be consistent with the objective put forward in the Madrid Declaration of significantly reducing fiscal deficits beyond the effects of cyclical recovery and cutting the debt/GDP ratio. The same question might be asked with respect to other countries, including some in my own constituency. Comments from the staff would be appreciated.

As to the question of whether it would be better to organize the discussion on the follow-up around specific themes, such as fiscal policy and structural reforms, instead of using the country-by-country approach applied in the present survey, I think the answer is quite straightforward. The Madrid Declaration reflects the obligation of countries to follow specific policies and the results must thus be assessed for the individual countries. That does not preclude, of course, that, in addition, comments could be made on the general attainment of the objectives within the different policy areas, and comparisons between countries undertaken.

Let me now turn to how member countries have performed compared to policy objectives they committed themselves to in Madrid. Overall, monetary policy seems generally to have been consistent with the Madrid Declaration, at least as far as major economies are concerned. Countries that are well advanced in the business cycle have tightened monetary policy at an earlier stage than in previous recoveries. Progress on the fiscal stance, however, has been insufficient. It is disappointing that only two countries, the United Kingdom and Germany, seem to have adopted medium-term policies that are sufficiently ambitious to meet the objectives of the Madrid Declaration. Admittedly, six months is a fairly short period, but the Interim Committee rightly underlined the urgency of starting the correcting action without delay. The recent unrest in foreign exchange markets may partly be attributed to the prospect for lasting fiscal disequilibria in several countries, and further demonstrate the urgency of decisive fiscal action to reduce the burden on monetary policy in fighting inflation.

In light of this, perhaps the policy assessment and prescriptions given in some of the individual country reviews could have been clearer. In the case of the Netherlands, for instance, the authorities are encouraged to let the automatic fiscal stabilizers operate during the upswing to prevent a deterioration of the deficit in structural terms, but that falls somewhat short of the goal of achieving fiscal adjustment beyond the effects of cyclical recovery.

In the structural area it is even more difficult to judge the adequacy of the efforts made so far. Indeed, there is little attempt made to evaluate whether measures that have been taken meet the expectations of the Madrid Declaration. However, structural reforms take time, and it is unrealistic to expect fundamental changes to have taken place over the relatively short period since Madrid. Structural reforms are still proceeding at a rapid pace in many developing countries and transition economies where the need is also greatest. This is probably mostly driven by forces other than the Madrid Declaration, but is welcome nonetheless.

The staff paper, in my view, correctly points to the area of institution building as a priority area of future reforms in transition economies. In developing countries the progress achieved so far needs to be consolidated and expanded. Of special concern is the fact that the volatility of exchange and capital markets may cause a reversal of the spectacular trade liberalization that has taken place in recent years. Although reversals so far have been minor relative to the progress made in recent years, they point to an underlying problem that needs to be addressed.

At the same time, it is obvious that structural impediments to full employment in many industrial countries are extremely entrenched, and reform efforts, especially in the labor market, are proceeding too slowly. Here I agree with the staff's assessment that more concrete actions are needed in the structural areas, not least in labor markets.

By giving greater importance to the Madrid Declaration, a review like this should enhance the Interim Committee's role as a forum for surveillance and policy discussions. It can sharpen the surveillance discussion within the Interim Committee as well as the Executive Board, and so complement the Fund's regular surveillance activity. In my view, it would be useful to produce a paper like this one on a regular basis to be discussed in connection with the World Economic Outlook (World Economic Outlook) exercise. This would allow for a continuous follow-up of the Interim Committee's declaration and communiques. However, careful thought should be given to the format and direction of the discussions in the Executive Board and the Interim Committee, as well as to the documentation presented, to achieve maximum beneficial effect and avoid possible pitfalls. For instance, I think it is very important that the Board discuss the individual country assessments, and that the Ministers are well aware of both the staff's and the Board's assessments, not least of their own countries. To have the one-page reports formally included in the documents given to the Interim Committee is perhaps not strictly necessary, even though this chair would not object to it. More important would be that there was an understanding that Ministers in their statements circulated prior to the meeting assessed the results of the follow-up, in general, and especially addressed what was being done in their own countries if the staff and Board assessment had been fairly negative. This would give other Ministers a chance to respond to their colleagues in their oral interventions. To enhance frankness and confidentiality, this could take place in a restricted session, perhaps with only Ministers and management present. I would also assume that the

Committee would generally assess the progress or lack of it in the communique, and urge the lagging countries to strengthen their efforts, but perhaps stopping short of naming them publicly.

Mr. Daco, speaking on behalf of Mr. Kiekens, made the following statement:

The Madrid Declaration lists the policy actions deemed necessary to exploit to the maximum extent the opportunities provided by today's more global and integrated world. The principles underlying the Madrid Declaration continue to gain wider acceptance: the need for fiscal restraint in the industrialized countries; the necessity of greater labor market flexibility in the European countries; the importance of trade and price liberalization in the developing countries; and the urgency, inter alia, of a broad range of structural reforms in the transition countries. It is true that the whole house can only be put in order if each starts by putting his own room in order in ways that do not disorganize his neighbors' rooms or the common areas of the building. The task of correcting policies has been made all the more urgent by the ongoing globalization of the economy. Times have changed and the world is no longer influenced solely by the policies of the Group of Three or Group of Seven countries. It is sufficient to recall Mexico's crisis and the turmoil it provoked in the world exchange markets.

All these considerations justify the proposal that members of the Interim Committee should monitor the implementation of the Madrid Declaration, based on country material, in order to enable the Committee to better assess world economic problems and agree on the policy actions required to address them. But such monitoring can be useful only if all members agree to participate in the cooperative spirit that prevailed in Madrid. I will address two questions that occurred to me while reading the staff document: are all the elements of the Madrid Declaration still relevant; and does the preliminary staff paper presented today meet the goal of an in-depth assessment of the implementation of the recommendations of the Madrid Declaration.

On the first question, I think the basic agreement on the propositions underlying the Madrid Declaration remain intact except on one point: the prompt removal of obstacles to the free flow of capital. Recent events have reminded us that a country exposed to capital inflows, given their volatility, may encounter great problems once the direction of the flows reverses itself. We have also seen, in various forums and in this Board, suggestions for temporarily protecting or insulating other countries from the contagious effects of such a crisis. As President Santer of the European Union stated, "there is a need for a consolidation of our international institutions, their authorities and their means of actions, in particular through the formulation of new rules adapted to the globalized markets." We may well wish to revisit this issue. I do not dispute that a member country's best response to the markets is to implement credible macroeconomic policies, but given the fragility of economies just emerging from an adjustment, we should be cautious about insisting that all countries immediately remove any obstacles to the free flow of capital.

On the second point, the implementation of the Madrid Declaration, subsumed in the staff paper's first two issues for discussion, I would like to make the following comments. It seemed to me that the tone of the paper is rather negative about the progress member countries have achieved so far. Little time has elapsed since the Madrid Declaration, and our judgment of the actions of member countries should take this into account. At the same time, if the assessment had turned out to be an exercise in self-congratulation, it would have missed its mark. The change in mood that has taken place between Madrid and today, despite the improvement in fundamentals during the interval, provides painful proof that the agendas of many countries remain full. The staff's paper identifies the most pressing economic problems still to be addressed in the countries covered by the study. I broadly agree with the staff's finding that fiscal policy actions have not been strong enough, which in some countries poses the risk of overburdening monetary policy. My remark on the shortness of the period between the declaration and the present assessment applies with particular force to structural reforms, which must be carefully designed and implemented to ensure proper sequencing and avoid spillover effects. This being said, I join the staff in regretting the fact that progress in the structural area has not been more forceful.

In passing, let me note that one of the major difficulties of this exercise is illustrated by a country in my own constituency. The fact sheet for each country in the study contains all relevant information and identifies the issues to be addressed. However, as Mr. Clark pointed out, these fact sheets are snapshots of a dynamic process and therefore require constant updating. My Hungarian authorities, for example, announced this week a set of policy measures aimed at curbing the current account deficit. The fiscal deficit--excluding privatization proceeds--will be reduced to a level broadly consistent with the staff's recommendations. The currency has been devalued, and structural measures are planned.

The provision of country-based information will enable the Interim Committee to assess the implementation of its Madrid recommendations and discuss the lessons, good or bad, to be learned from the conduct of economic policies across the membership. It might also allow for some peer pressure to be exerted during the Interim Committee meetings, although this should not be a primary objective. I much prefer the idea that this type of exercise can contribute to a dialogue among Ministers on how best to correct economic maladjustments. It would also be extremely useful if the exercise could help make the Ministers of the largest industrial countries more aware of the externalities of their policies, but on this last point, the report is rather disappointing. I note that the Madrid's declaration states that the entry into force of the Uruguay Round increase global economic integration and thereby improve world economic prospects. The global integration of financial markets should lead to greater cooperation, since the problems which are now becoming worldwide will require worldwide solutions. It is a major weakness that the report simply juxtaposes separate assessments of the economic policies of the major member countries without addressing the linkages between their economies. I suppose that this weakness can be corrected by the World Economic Outlook and that a chapter discussing these linkages will eventually form part of the report on the implementation of the recommendations of the Madrid Declaration that the Board will submit to the Interim Committee.

Finally, let me stress that due care must be taken to ensure that the follow-up report does not breach the confidentiality to which member countries are entitled. The results of the exercise must therefore remain restricted to the Ministers. I also think it could be counterproductive to insist on the inclusion of an individual country's "snapshot" assessment in the report to the Interim Committee. At this stage we might be better served if the discussion at the ministerial level concerned the body of the text instead of concentrating on the problems of specific countries.

In closing, I wish to commend the staff for producing this paper in the relatively brief period since the Madrid meeting. It was a rather difficult exercise, the more so since its purpose was never really discussed in detail between the staff and the Board. Any flaws we may detect in this paper should be ascribed to its pioneering nature. The present review should certainly permit us to take better aim at the mark: it is a first step toward the important goal of strengthening surveillance. In view of the degree of integration of today's world economy and the continuing globalization of financial markets, all countries would benefit from such a strengthening, provided that we continue the exercise with caution and in a spirit of consensus.

Mr. Shaalan made the following statement:

This is an important subject with potentially far-reaching ramifications for the institution and its membership at large. Last fall's Interim Committee communiqué highlights surveillance, which is at the core of the Fund's responsibilities, as a function that needs to be enhanced. I do not believe that any of us can disagree with the importance that needs to be attached to carrying out this responsibility effectively. Undoubtedly, the Mexican crisis and the resulting ripples, in some cases more than ripples, underscore the importance attached to this subject.

The paper before us represents a first attempt to respond to the Committee's call for a progress report on the Madrid Declaration. And I wish to thank management and the staff for their initiative in attempting to address this issue. However, one must legitimately ask the question whether the modality--namely, one-page statements on each of the 49 countries to be presented to the Interim Committee--is an effective or even an appropriate vehicle to enhance this function. I have serious reservations on this approach for a variety of reasons. One-page notes are too cryptic and could not possibly convey to the Interim Committee a picture that is sufficiently complete, and could even be misleading in nature. This would be most unfortunate and counterproductive.

Many of the 49 countries covered in the report have not had a recent Article IV consultation with the Fund. Any factual or policy statements about countries should emerge from recent summings up, supplemented by discussions with the authorities as needed.

One must not underestimate the dangers emanating from possible leaks and the resulting potential impact on the markets. Surely, if it is known that the Interim Committee has before it one-page statements on the economic policies of 49 members, the risk is high that there will be those who will go to great lengths to obtain copies or information. Should this materialize, the trust that we have built over decades between the institution and the membership could well erode. Confidentiality will have been breached with damaging consequences to the very process of surveillance which we are trying to enhance. I would caution in the strongest terms against this course of action.

As regards multicountry constituencies, the proposed format could entail difficulties for Committee members representing multicountry constituencies that cannot and should not be ignored. There are clear limitations as well as sensitivities to having a Committee member get into a discussion on the policies of a country not in his or her own constituency.

I believe that bilateral surveillance should remain first and foremost a task of the Executive Board on the basis of staff reports. It is inconceivable that the Interim Committee could focus in an effective manner on 49 countries in a matter of one or maybe two hours. The Interim Committee, however, needs to have a role in the surveillance process.

Let me, on a positive note, make a proposal on an experimental basis for the consideration of the Board. I start with the proposition that surveillance at the Interim Committee level should not focus on the individual country situations. The documentation for the review of the Madrid Declaration should instead be based on the summings up of the Article IV consultations during the six months prior to the Interim Committee meeting, with factual updating as needed. The Executive Board would review policy measures taken or considered by member countries and draw conclusions, particularly along regional and thematic lines. These conclusions would form the basis for the report for the consideration of the Interim Committee. Such a report would not be too dissimilar from the introductory chapter of the paper before us, which focused on policies in industrial and developing countries and economies in transition. It would avoid the pitfalls of the individual country notes that I outlined. This procedure should be assessed after the Interim Committee meeting to see how it can be amended or strengthened.

Mr. Kafka made the following statement:

The paper before us raises major concerns. We are expected to report on progress under the Madrid Declaration to the spring meeting of the Interim Committee. I am convinced that the best way to do so is not by giving the Interim Committee a list of 49 country notes. I am very much in agreement with what Mr. Shaalan has said and also what he has proposed. It is hard to believe that such a list--under the best of circumstances--could lead to a profitable discussion especially at a one-day meeting. There is too much to digest for the members, even on one-page notes. Such short notes can be problematic--a matter I shall return to shortly.

What would be useful is for the staff to present us with a discussion, more searching than has been our practice, on categories of deviations from appropriate policies. It would, in that case, not be necessary to enter into detailed analyses of individual countries' policies at the Interim Committee level. Is this a practical proposition? I believe it is. We can strengthen surveillance--which we all want to do--by discussing categories of deviations. I think it should be left to each country's Executive Director, management, and the staff to translate the resulting message into practical suggestions to the individual countries they represent or deal with. I doubt that this would detract from the force of the message. All too often a Fund mission discovers quite obvious mistakes in a member country's analysis of its own situation and proposals to correct it. Anything the staff says will therefore be received with the utmost seriousness. The Managing Director's opinion will be received with the same seriousness at the higher levels of government. In other words: the quality of the Fund's advice--quite apart from the advantages the Fund can offer or withhold--assures that it will be as effective as circumstances permit it to be.

There is another matter that has to be considered in this context. It concerns the Fund's evenhandedness. I am not, of course, suggesting that treatment is discriminatory, but that similar treatment may have a differential effect. Thus, knowledge that in the Fund's judgment a country has an unsustainable fiscal deficit may have no effect at all in the case of a major member, but a devastating effect on a small country. This imposes a special duty of carefulness on even uttering such judgments.

We are also concerned by statements on individual countries that are imprecise or even misleading--if so, of course, inadvertently. But for an institution such as ours to distribute that type of information can be dangerously damaging to the country concerned and to the Fund. I obviously do not want to bore the Executive Board with individual cases. But I do want to cite just two, and will talk or write to the staff on others.

With respect to Brazil's consumer prices, Table 1 shows an annual consumer price increase for 1994 of 2,407.3 percent. What the table neglects to indicate in any manner is that there was, in 1994, a radical monetary reform. As a result, the monthly average rate of inflation fell gradually from 50 percent in June to 1.66 percent during January-February 1995, though it may be slightly higher since the recent devaluation. The point to remember is that it makes no sense to circulate data, without qualification, according to a uniform scheme, when that scheme is obviously meaningless in the particular case. At a minimum, Table 1 should have had a footnote, citing the monetary reform and the subsequent results.

With respect to Colombia, Table 2 shows a fiscal deficit for 1994 of 1.5 percent of GDP, while the staff report for the Article IV consultation--which was thoroughly used in the country summary--shows a surplus of 0.3 percent of GDP.

In conclusion, to strengthen surveillance: the Executive Board, in conjunction with management and the staff, should improve our information without imposing wholly uniform schemes for the publication and circulation of data; we should make increased use of follow-up contacts--not necessarily missions--including messages from the Managing Director and, in some cases, bringing countries' reactions to the Executive Board. The right use to be made of the Interim Committee is not with individual country discussions, but rather with thematic discussions of developments of general interest whose message would be understood, where appropriate, as applicable to individual countries even without naming them in documents. The message would be spelled out by the staff, Executive Directors, and the Managing Director. In this way, we shall carry out the mandate of the Interim Committee discreetly as well as effectively.

I am not commenting, at this point, on the specific conclusions to which the staff paper leads. I believe that the general statement on pages 1-8 is basically appropriate.

Mr. Waterman made the following statement:

I would like to stand back and make some observations about this paper in the context of our more general efforts to improve surveillance. On that, there is fairly general agreement that surveillance is not working as it should. We put much time, work, and resources into it, but we have very slim pickings in terms of anticipating problems and getting countries to take offsetting measures in time to avoid problems becoming worse than they should. In saying that, I recognize that we cannot always expect to see the results of our work when we are working effectively, but there are too many examples in which things have been derailed.

We strongly support management's efforts to improve our performance and we need to try new approaches. And in doing that, we do not always know what is going to work before it is tried. Thus, I support this experiment, even though I do not know whether we have found a useful way forward with the particular approach. The general lessons from the countries covered could be picked up in Ministers' discussions of the World Economic Outlook--Mr. Clark and Mr. Bergo drew these out in their statements. But, like some others, I have doubts as to whether Ministers will have the time or the inclination to enter into a detailed discussion of individual countries at the Interim Committee meeting. If that is to be tried, I agree with Mr. Bergo that it would be done best in a restricted session, perhaps luncheon discussions. However, I still have some reservations about how effective it might be. Let us face the fact that most Ministers have enough problems of their own without buying into those of someone else. We also have a basic problem with the limited number of Ministers who are represented at the Interim Committee meeting. To be effective, discussion would also need to be limited to a few countries.

To be more positive, the job of improving surveillance is something that has to be handled largely by staff, management, and the Board working together; and I suspect that is the attitude of many Ministers.

We can nevertheless seek ministerial support for our surveillance work in terms of such matters as ensuring that all countries are producing comprehensive and timely statistics on their economic performance, and for what could be described as a more aggressive approach to surveillance. But the main focus, I suspect, needs to remain with us. We have already had some discussion on how we can make the Article IV consultation process more effective by making reports more direct, differentiating more sharply between the performance of economies, and redirecting our resources and efforts onto the problem or potential problem cases.

Some useful ideas have also been put forward by Mr. Geethakrishnan and others about making the informal reports on country matters a forum for identifying problem cases, and--as I think Mr. Kaeser has argued--we do need to have an ex post assessment of programs by an evaluation unit--or somebody--when they go off-track. There is also the proposal by management to maintain a somewhat higher level of surveillance over those countries that have borrowings from the Fund after the period of drawings has been concluded.

We have to accept that we will not receive public recognition for some of the work that the institution does, particularly the more discreet counseling provided by the Managing Director and senior management to countries with problems. But I support further work in that area. Surveillance failed in the case of Mexico, but the approach adopted by management in the case of Sweden and Hungary seems a good model to me, even though the results may not be all that we would like. At the end of the day, we can only take the process so far; the domestic political processes need to take over at some point--our discussion on Italy this morning is a case in point.

If we ensure that the basic data on economic performance gets into the public arena on a timely basis and that we draw the attention of officials and governments to potential problems, that may be as far as we can take the process in the absence of a Fund-supported program. However, we can help with the provision of technical assistance to improve statistical systems in some countries. It is very difficult to make early calls on potential problems of a general nature, or on more specific country issues, but it can, at the same time, be very useful. Given all the uncertainties, the message needs to be conveyed diplomatically at first. But if early advice goes unheeded and the problem develops--or grows worse--a louder message is appropriate. I would not necessarily rule out a role for Ministers, but perhaps that is best left for them to decide individually rather than to use a forum like the Interim Committee to deliver a message. However, I am interested in the comments of others.

Mr. Ismael made the following statement:

Let me begin by stating that I am much in agreement with the statements of Mr. Shaalan and Mr. Kafka. Having said that, let me also hasten to say that the Madrid Declaration represents an important avenue for fostering closer involvement by the national authorities and political leaders in a cooperative effort to ensure that policies in their respective countries are tailored toward the achievement of a common objective, namely, a stronger global economy for all. However, I am not convinced that the staff's approach in reviewing policies in individual countries is the best way to achieve this noble objective. In fact, it might actually be counterproductive, as this would place the Ministers in an awkward position of having to defend their policies among their peers in the Interim Committee. The circulation of individual "report cards" might also precipitate a confidence crisis in the "delinquent" countries, which could have dire consequences, as amply demonstrated by recent events. Some countries may also seize upon such report cards to press for policy changes that they were not able to elicit on a bilateral basis, on the grounds that their demands are legitimate, as the Fund is also "on their side."

In view of these rather disturbing considerations, I have strong reservations about the wisdom of the present format for reviewing the implementation of the Madrid Declaration based on the individual assessments of 49 member countries. The utility of such a format is also suspect, as systemic issues are not adequately addressed. In this regard, I would favor a more "macro" approach, whereby the staff assesses the policy environment on a geographical or regional basis. Such an approach would avoid the problem of embarrassing individual Ministers by not referring to specific countries, while at the same time, making it amply clear where policy changes are called for.

Having said that, I would now like to focus my comments on the review of progress in implementing the Madrid Declaration. It would be an understatement to say that the world economy has witnessed many significant developments since the Madrid Declaration in October 1994. On the positive side, the successful conclusion of the Uruguay Round and the entry into force of the World Trade Organization on January 1 argues well for a continued expansion in world trade and growth. At the same time, the generally favorable economic outturn in the major industrial countries, in an environment of robust growth with relative price stability, should further strengthen the global expansion.

Similarly, growth in the developing countries has been sustained at a rapid pace.

Against this rather rosy backdrop, however, several policy challenges remain, which--if left unchecked--could undermine the progress made toward the successful implementation of the Madrid Declaration. As most of these challenges--such as high structural unemployment as well as the lack of progress in privatization and structural reforms--have already been highlighted in the paper, I shall confine my comments to a few issues, which, in my view, should also be addressed in the paper.

First, as I noted earlier, the staff's approach in providing a review of economic performance and policies in individual countries may not be the best way to analyze the progress in the implementation of the Madrid Declaration. We need to look at the "big picture," namely, progress in promoting policy coordination, particularly among the major industrial countries, in order to maintain a conducive environment for world trade and growth. In this regard, it would be useful if the paper could discuss some of the more "macro" policy issues, such as recent developments in the exchange rate mechanism and the depreciation of the U.S. dollar--and its implications for the global economy. This is particularly relevant in the wake of the realignment of parities for the Spanish peseta and Portuguese escudo, and the recent currency movements of the U.S. dollar, deutsche mark, and yen. Also important is the need to address the impact of these movements on developing countries, especially on their external debt problems, and how the Interim Committee as the overseer for the adjustment process can influence exchange rate policies to the benefit of the global economy.

Second, although it may be outside the original mandate of the Madrid Declaration, I strongly feel that the paper would be incomplete without a discussion of the policy implications arising from the recent turmoil in international capital markets. A proactive, rather than a reactive, approach is called for here, as the issue is very relevant in view of the important lessons that can be drawn from the Mexican and Barings' crises. In the process, we could--it is to be hoped--help to ensure that the global economy is better prepared to deal with such external shocks in the future.

Third, the Mexican and Barings' crises also underscore the need for closer collaboration among national authorities to monitor and supervise cross-border capital flows more closely and effectively. In this regard, I believe the Fund should take on the lead role in supervising the international capital markets as part of its surveillance function, if need be, in collaboration with the Bank for International Settlements or the OECD.

Incorporation of the above issues and considerations into the paper would, in my opinion, provide a more useful review of the progress toward the implementation of the Madrid Declaration.

Mr. Berrizbeitia made the following statement:

In its Madrid communiqué, the Interim Committee affirmed its "intention to reinforce the Committee's role in the process of policy cooperation and coordination." In particular, the Committee referred to the ongoing effort to enhance the Fund's role in the international monetary system, and to strengthen Fund surveillance--including multilateral surveillance and work on capital markets.

Since the enhancement of the Fund's role in the international monetary system will be the subject of another Board discussion on March 24, I interpret our discussion today as concentrating on the means by which the Interim Committee can be more actively and productively engaged on strengthening the surveillance process, in the context of the implementation of the Madrid Declaration.

At the outset, let me say that a country-by-country approach does not appear to offer the most appropriate, nor effective, method to effectively engage the attention and reaction of the Interim Committee members, and I welcome the flexibility indicated by Mr. Bergo and Mr. Daco in this respect. Indeed, Board members have expressed serious concerns regarding the confidentiality of such documents in the context of the Interim Committee meeting, their uneven quality, and their lack of methodological uniformity, which could result in an unbalanced impression of the Fund's surveillance work.

There are also practical issues involved in addressing surveillance on a country-by-country basis at the Interim Committee meeting, among which are the time constraints involved, the resulting need to concentrate on a very few countries, the fact that for many chairs with multiple constituencies it is not possible for all Governors to participate, and the likely counterproductive effects of singling out individual countries and Governors for concentrated critiques by his or her peers, as we are accustomed to in the Board.

Additionally, the country-by-country approach does not easily lend itself to focusing on some of the broader thematic issues and regional considerations, which require the attention of the Interim Committee, and which could better help to bring out Madrid-deviant policy behavior, and thereby contribute to eliciting the type of response we wish to obtain from the Interim Committee members.

This said, my chair agrees with the need to make further progress on strengthening the surveillance process and to actively involve the Interim Committee in that process. I would therefore like to make some specific suggestions that, it is to be hoped, will contribute to lead us in that direction.

Like Mr. Shaalan and Mr. Kafka, I feel that a strengthened version of the introductory write-up contained in the document that was distributed for today's meeting could serve as a basis for the type of report that the Board could present to the Interim Committee. This introduction systematically attempts to touch upon most of the basic issues raised in the Madrid Declaration and appropriately refers to specific countries, whether critically or positively, in the context of the broader issues with which it deals.

I would have no objection to strengthening the document by increasing the number and augmenting the content of references to individual countries, based on the summations of Article IV consultations, and updated where appropriate. In this manner the report could better highlight individual country progress, or the lack thereof, toward implementing the cooperative strategy agreed upon in Madrid, without presenting one page reports out of context.

I also feel that a regional approach would be more useful in dealing with country groupings. This would allow a more effective interweaving of common themes across countries whose economies are more closely interdependent, thereby increasing the potential effect of peer pressure on any given country. In this manner, it is more likely that, in their statements, Ministers would address what was being done in their own countries, especially when the Board's assessment had been fairly negative, as suggested by Mr. Bergo. Furthermore, Executive Board members would have the responsibility of pointing this out to our Ministers.

At the same time, I would also like the Board's report to better balance the country based approach of the current introductory chapter with the focus on multilateral surveillance which the Interim Committee mentions in its communiqué. In this context, I concur with Mr. Daco on the need to "make the Ministers of the largest industrial countries more aware of the externalities of their policies."

In particular, my chair attaches the utmost importance to highlighting the issue of the magnitudes and volatility of global capital flows; how these are affected by the fiscal, monetary and exchange rate policies of the countries whose currencies constitute the principal international reserve assets, as well as by trends in savings behavior in those countries; the regional implications of such policies and capital flows, and their effect on the economies of developing countries and emerging markets. All of this aims at pointing out the need to "reinforce the Interim Committee's role in the process of policy coordination and cooperation" in this particularly critical area of global capital markets for strengthening the global expansion.

With this approach, the Board would contribute positively and effectively to sharpening the surveillance process, by presenting a balanced yet thought-provoking document to the Interim Committee, which would provide it with a practical opportunity to become more actively engaged in surveillance and policy discussions, without unduly singling out specific members out of a broader context.

As regards the assessment itself of the implementation of the Madrid Declaration, while I generally endorse the focus of the introductory write-up to which I have been referring in this statement, there are factual clarifications, corrections, and updating that may be needed, in addition to a better linkage between references to countries and regional and thematic issues, as I have been suggesting. Although I concur with many of the specific comments made by Mr. Clark, Mr. Bergo, and Mr. Daco in their statements, it would be preferable to wait for a revised version to be produced by the staff, along the procedural lines which we will hopefully agree upon today, before entering into specific details.

Ms. Lissakers made the following statement:

I would like to comment on both the substance of today's paper and the general procedures for following up on Interim Committee decisions.

First, I think we are on the right track in trying to make better use of the Interim Committee to make Fund surveillance more effective. The Madrid Declaration serves as a focal point for this effort. It presents a summary judgment of where the Interim Committee thought the world economy was headed, what the most important policy issues seemed to be, and how the Committee thought countries ought to orient their policies in the period immediately ahead. Focusing our follow-up around this declaration will give more weight to the continuing surveillance work of the Fund and more weight to the work of the Interim Committee.

Second, I think we should emphasize that the Interim Committee Communiqué and the Madrid Declaration are integral parts of Fund surveillance; they are not something apart from our regular, ongoing work in this area. Each layer of the surveillance work has its role. The Interim Committee is the point for broad assessments and for mobilizing support among national leaders for common efforts.

I make these general observations because I think they have a bearing on how we proceed with this review of the implementation of the Madrid Declaration.

One thing that struck me in reading the staff preliminary review is that the Madrid Declaration seemed to be being treated as something apart from our ordinary surveillance work. The first part of the paper, the broad overview of economic developments and policy trends, is factual and largely unobjectionable, but not analytical. This is not surprising since it was written before, not after, our World Economic Outlook discussion. I think we would serve the Interim Committee better if we reported on the implementation of the Madrid Declaration based on the deeper analysis of economic developments that will be provided in the World Economic Outlook. If we are going to try to involve the Interim Committee more in the work of surveillance, we ought to give them the benefit of our best work.

Another point was brought home in reading Mr. Bergo's statement: I think we need to be clear about what the Madrid Declaration is and what it is not. I think Mr. Bergo strains a bit too far in seeing the Madrid Declaration as "a formal commitment to follow sound economic policies," and further, that "the Madrid Declaration reflects the obligation of countries to follow specific policies...." In fact, the language of the Declaration is repeatedly "the Committee urges," rather than "the undersigned pledge." Thus, we ought to be somewhat judicious in drawing judgments about whether individual countries have or have not lived up to their commitments under the Madrid Declaration. We are engaged in a process of international cooperation, not contract enforcement. What I think we want from statements like the Madrid Declaration is a mobilization of the collective judgment of the international community that will encourage and reinforce the efforts of national leaders to develop economic policies that are in their own best interests and in the interest of the international community.

In this regard, I think our evaluation ought to include consideration of whether member countries are adapting themselves to the world as we see it evolving. Part of the work of the Interim Committee is to draw conclusions about the major trends in the world economy. If the conclusion is, for example, that industrial countries are going to be implementing firmer monetary policies, are members adapting their policies to this fact? If the conclusion is that private markets will play a greater role in intermediating international capital movements, are countries adapting to this development? This is a point I raised in our recent discussion of surveillance (EBM/95/17, 2/17/95) but I think it fits also into our evaluation of the Madrid Declaration or other follow-up on Interim Committee communiqués.

The preliminary review contains one-page summaries of developments in 49 countries. I have mixed views about these one-page summaries. At the practical level of expediting the work of the Interim Committee, I think the one-page summaries could be quite useful. With these write-ups in their folders, Ministers would not need to spend one half of their speaking time reviewing developments in their constituents' economies. I am also sure there are countless staff assistants in finance ministries around the world who will be happy to have authoritative one-page summaries of developments in foreign countries.

I also think it is useful to have a vehicle for the staff to provide an updated description of developments in a large number of individual countries separate from the Article IV cycle.

These advantages notwithstanding the one-pagers, are--unavoidably--not very analytical. They do not provide a basis for making a clear assessment of countries policy stances. They cannot provide the kind of judgments that can be drawn in the summing up of Article IV consultations. Thus, they are of limited usefulness in trying to evaluate how well the Madrid Declaration is being implemented.

Let me make a couple of brief comments on the substance of the preliminary review. The world has turned somewhat since last October. There have been major upheavals in currency markets, the Mexican payments crisis has sent shudders through Latin America, and Russia and Ukraine have adopted major stabilization programs. As the Madrid Declaration includes a view as to how the world is likely to evolve, an evaluation of the Madrid Declaration ought to make a somewhat more prominent mention of these important developments.

Extending her remarks, Ms. Lissakers said that she favored submitting the one-page country notes to the Interim Committee. Directors who were concerned about "leaks" to the public were perhaps being overly sensitive, as the country notes did not contain exceptionally damaging information. A regional approach to assessing countries' progress, although useful in some cases, would not be appropriate in general because of the vast differences that existed among countries in the same region. An approach that combined an analysis of broad trends in the world economy with the individual country notes could provide a basis for a useful document for the Interim Committee's review. Such a procedure could be tried on an experimental basis.

Mr. Autheman made the following statement:

I find the principle of this review very useful, and I will not criticize the staff for the shortcomings of its report which are inherent to its experimental nature. I agree that it is useful, both for this Board and for the Interim Committee, to monitor the implementation of the Declaration issued by the Interim Committee. We must be careful not to forget this Declaration when we find shortcomings in its implementation. I also find it useful to try to establish a bridge between our multilateral and our bilateral surveillance. This bridge, in my view, should go both ways.

First, it could be useful to take the opportunity of the preparation of the World Economic Outlook to make some cross-examination of our bilateral surveillance, not to repeat Article IV consultations but rather to check for consistencies in our case-by-case approach with a more synthetic one. Indeed, this exercise could help us achieve greater selectivity in our bilateral surveillance.

Second, I think that this process could improve our multilateral surveillance, but here we need to identify what should be done by the staff, by the Interim Committee, and by ourselves. By "ourselves," I mean management and the Board.

As to the staff: I see this exercise as useful input for the preparation of the World Economic Outlook. I presume it has been useful for the staff, and I think it can be useful for us, to be informed of the country analysis on the basis of which the staff has worked.

Second, this exercise can help us achieve a satisfactory evenhandedness in World Economic Outlook. In the past, the World Economic Outlook has been mainly focused on industrial countries and transition economies, and was usually very general about developing countries, especially on important developing countries benefiting from access to capital markets. We must be careful to meet the expectations of those who read this report seriously.

Yesterday I attended a World Bank colloquium where three global portfolio managers tried to explain how they made their investment decisions, and they all presented charts derived from the World Economic Outlook. One of them, who seemed to have had very active involvement in Latin America, mentioned that he met quarterly with Fund the staff.

I think we must be careful to maintain the right balance between the information given by the staff in private meetings and public information given in the World Economic Outlook. Readers would not understand it if we did not make a significant improvement in developing countries' coverage in World Economic Outlooks following what happened in the recent months and preceding what may happen in the future.

I was also pleased to see that some progress could be made in working on key indicators. Indeed, when one looks at growth, inflation, the fiscal position, and the current account position, there is a wealth of information provided; I would only ask for a fifth indicator: exchange rate variations.

As far as the Interim Committee is concerned, I see no merit in a discussion of country cases by the Interim Committee. Even we, in two-and-a-half hours, are not able to comment on the 49 country pages; and I do not see how the Interim Committee could do it, unless we decided to prepare a short list of high-risk countries. But such a process would produce much more damage than benefit. So I see no case for considering country discussions by the Interim Committee.

What we should ask the Interim Committee to do is, first, look backward and, second, look forward. To look backward is to assess how the Madrid Declaration has been implemented. Where have there been shortcomings? Should we satisfy ourselves with progress in monetary policy and fiscal policy, or should we, as I think, express some concern that our recommendation in the area of monetary policy still falls short of what is needed and some concern over the slowness of fiscal consolidation in too many countries?

But we should also ask the Interim Committee to look forward to address two questions: did we overlook some important risks in the Madrid Declaration; and what are the new risks which we must address now. In this regard, the evolution of exchange markets during the past three months is an important warning signal for us in the preparation of this work.

As to ourselves, the management and the Board, I think that the bulk of the task of strengthening our country surveillance will rest with us. I have one question for the Chairman. Do you think that the monitoring of the Interim Committee Declaration should trigger management initiatives in its bilateral contacts and follow-up procedures with some countries? This could send a useful message to some countries that, in presenting their successful achievements to the international community on the occasion of the Interim Committee meeting, we should also take into account the warnings they may have received from management.

With regard to the Board, I would be ready to take part in more active surveillance in countries that may encounter severe problems. I think this would prevent us from entering public debate on whether the Fund's past actions were what was needed or not. But to do this, we need your contribution and your readiness. Do you wish to report to this Board on the various initiatives taken by management on the basis of Article IV consultations, of world economic and market developments, or of Interim Committee discussions? Or do you wish to keep private this follow-up relationship with countries and to limit the information of the Board to allusive comments?

I am aware that this is a difficult issue: you are pressed by countries to keep an allusive approach and it is difficult to discuss candidly the reasons why, in some cases, Article IV consultations are delayed. Some reports cannot be made. But I think that if we want to strengthen our surveillance, we have to address this issue.

I continue to consider that this Board can work in a very confidential way and that the need to protect confidentiality should not prevent us from considering this option.

The Chairman remarked that surveillance was a permanent feature of management's work. In his discussions with member authorities, he always had the relevant summings up at hand to remind the authorities of the Board's views. If there were particular areas of concern, those were also discussed. It was incumbent on management to engage in such dialogue. On any given day, he met with at least two or three ministers, and he did not see how he could inform the Board about every discussion held between member country authorities and management. Following an important Board discussion of a country, it had been management's practice to comment on the summing up in its communication with the concerned authorities. In addition, there were cases of countries facing serious difficulties, but which were reluctant to engage in a dialogue with the Fund. In such cases, it was incumbent upon him to persuade the country to cooperate with the Fund; however, that required time, patience, and low-keyed diplomacy. It was difficult for management to report to the Board on those cases, until the end, when the country had agreed to cooperate with the Fund, or it was faced with a crisis, at which time the matter was brought to the Board's attention. Recently, he had warned a Prime Minister that his country could face a Mexican-type crisis. Although the crisis had not occurred, it had been his duty to forewarn the authorities.

Directors' views expressed at discussions of world economic and market developments, the world economic outlook, and Article IV consultations were other important ways for the Fund to step in to prompt the authorities to take timely action, the Chairman considered. The growing responsibilities of management, and the increasing importance of maintaining dialogue with member authorities, had been behind his invitation to the Board to increase the number of deputy managing directors, which had allowed management to increase its contacts with authorities. He would welcome other suggestions from Directors on how the Fund could enhance surveillance further.

Mr. Al-Jasser noted that the Fund, through the world economic outlook exercise, had been examining its surveillance of individual countries. The World Economic Outlook was the unique result of a collective effort by the area and functional departments at various levels, from desk economists to department heads, who combined their knowledge and expertise. As the world economic outlook exercise provided an opportunity to examine the Fund staff's work on individual countries, it was a precursor to the current exercise under the Madrid Declaration. For instance, at the time of the fall 1992 world economic outlook discussion, the Board--and later the Interim Committee--had discussed extensively the experience of successfully adjusting developing countries. At the spring 1994 world economic outlook discussion, the Board had discussed the reasons for the failure of certain countries to catch up, and it had once again drawn the attention of the Interim Committee to the experience of the successful countries. Also discussed at the time had been the objectives set out in the Madrid Declaration relating to the achievement of macroeconomic stability and ratification of the Uruguay Round and the issue of global saving, which would be discussed again in the forthcoming world economic outlook exercise. It was important not to lose sight of the beneficial work that the Fund had been doing through the world economic outlook exercise, and, perhaps, there was room to strengthen the Fund's work in that area. It was also important not to fall into the trap of criticizing all aspects of the Fund's work and to look for new exercises.

Mr. Kaeser made the following statement:

> I would like to begin by commending the staff for the excellent discussion paper produced for this preliminary review and by thanking my colleagues for their useful statements.
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> I will divide my remarks in two parts. First, I will address the process and methodology of the review, then the content of the discussion paper.
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> Concerning the methodology of the review, like Mr. Bergo, Mr. Daco and other colleagues, I think that the Madrid Declaration reflects the commitments of our member countries to follow specific policies and that the review of its implementation has to be based on country material. I like the approach consisting of tabling short fact sheets for the countries under review. These fact sheets draw attention to the essential aspects of the macroeconomic situation and policies in the countries. What does not appear in the fact sheets is in most cases irrelevant in the light of the Madrid Declaration. I agree that these fact sheets need to be updated in some cases, but, in my view, this is the proof that surveillance has to be a continuous process and that

the yearly Article IV consultations may not be sufficient to track important developments.

Although I like the fact sheets prepared by the staff, I would hesitate to include them in the official documentation submitted to Ministers. Like Mr. Daco and others, I think that it would be wise to forward only the main text to the Committee. As we know the creative restlessness of Ministers gathering in and around the Interim Committee room, we have to recognize that it would be better for the Ministers to give guidance and for the Board to implement it, that is, to discuss developments in individual countries. We are certainly better trained for this job. As to the follow-up of this exercise, I would like to support Mr. Geethakrishnan's idea to have periodic country matter sessions in which industrial countries, developing countries, and countries in transition alike could be under review. In order to avoid a negative connotation, the review should include countries that have made progress in implementing the objectives of the Madrid Declaration, as well as countries lagging behind the Madrid requirements. The summary of these periodic reviews could become a building stone for the world economic outlook papers.

Like Mr. Bergo, I think that, in order to improve the effectiveness of surveillance and building on the Madrid Declaration, the Fund will have to develop more tangible criteria of performance. If I remember well, Mr. Berrizbeitia made interesting suggestions in this respect at our recent discussion on surveillance. With Mr. Daco, I have nevertheless some doubt on the wisdom of insisting that member countries remove all obstacles to capital flows. The Madrid Declaration should be revisited on this point in the light of the recent turmoil on the financial markets.

This is disappointing as the main purpose of the Madrid Declaration was to immediately seize the opportunity of the recovery to take measures for strengthening growth and reducing unemployment.

Turning now to the content of the discussion paper, I would say that it gives a concise assessment of members' policies in light of the objectives set out in the Interim Committee's Madrid Declaration. Although the staff correctly underscores the short time span since the Madrid meeting, the report gives us a good opportunity to critically assess progress achieved so far.

The overall impression one gets from the report is that progress in implementing the policy objectives appears to have been very limited since last October, even when taking into account the brevity of the period considered. With the exception of the successful implementation of the objective concerning the

Uruguay Round, the policies of the countries reviewed have in most cases not significantly supported the attainment of the other policy goals set out in the Declaration.

As regards industrial countries, although monetary policy in most cases has been broadly in line with the goal of price stability, efforts in the fiscal area have been disappointing. Improvements of fiscal positions have come to a standstill in most cases and medium-term strategies to reduce budget deficits are not sufficiently strong. In our view, this lack of commitment toward fiscal consolidation has contributed heavily to the recent developments on the foreign exchange markets.

In developing countries, the economic situation, with few exceptions, continues to remain fragile at best. For many countries, external balances are at levels that are unsustainable in the medium term. In the fiscal area, high levels of inflation continue to necessitate a strengthening of adjustment measures. The economic fragility has increased in many emerging market economies following the recent economic and financial crisis in Mexico. In this respect we are somewhat surprised that the staff did not briefly explain the setbacks that this crisis has caused and will continue to cause for various developing economies. Regarding structural reforms, most countries appear to have difficulty in deepening the substantial progress they have achieved in the various areas in recent years. We agree with the staff that a comprehensive reform of the public sector and progress toward privatization must take place, in order to ensure sustained economic growth and financial stability in these countries.

As regards policies in transition countries, the staff's assessment is extremely brief and, therefore, remains somewhat superficial. However, in terms of the implementation of the objectives defined in the Madrid Declaration, progress appears to be extremely limited and in some cases important setbacks have been registered. Considering this difficult situation in many key transition countries, it would have been helpful if the staff had identified more precisely the most critical areas in which policy action is warranted. Shortly, we will have the opportunity to come back to this issue.

Overall, the report correctly identifies the critical areas in which policy actions are necessary. In view of the forthcoming surveillance discussions, it will be important to update the current analysis by taking into account the recent substantial movements of exchange rates of key currencies and their impact on progress toward achieving the economic policy goals defined in the Madrid Declaration. Furthermore, we would welcome a strengthening of the assessment concerning transition countries.

We will update with the staff the fact sheets concerning the countries of our constituency.

We agree with the thrust of the staff's assessment concerning Switzerland. According to the most recent figures, inflation in 1995 is estimated to rise to 2.5 percent, that is, slightly higher than the level mentioned by the staff. In the area of fiscal policy, the rejection of important parts of the consolidation program by both houses of Parliament has made the authorities' task more difficult. However, the recent plebiscite on expenditure reduction gave the authorities a clear signal that the budget deficit constitutes an important issue for the Swiss population. The approval of higher benchmarks in parliamentary voting procedures when new expenditures are involved should help contain expenditures in the future.

As regards the situation in Poland, I would like to mention that both chambers of Parliament have approved the Uruguay Round agreement. It is also worth mentioning that the new reshuffled Government expressed its strong commitment to speeding up structural reform, notably in the pension reform, and to going ahead with privatization. According to the announcements of the Government, the major decisions in the area of pension reform will be taken before the preparation of next year's budget. The new Government also announced that it will give high priority to the fight against inflation.

Concerning Azerbaijan, I would only like to mention that the unification of the exchange rate took place at the end of February.

Extending his remarks, Mr. Kaeser considered that the best way to avert a crisis was for countries to publish more data in a timely manner.

Mr. Mesaki made the following statement:

Today, we have a good opportunity to review the implementation of the Madrid Declaration with a compact but very illustrative staff paper. Although there seems to be some room for improving the staff paper, as indicated in Mr. Clark's statement, the one in our hands is a good starting point. First, I would like to comment on the issue of the time horizon. The Madrid Declaration describes the points to which the authorities should pay attention from a medium-term viewpoint. In the shorter term, developments in the financial and exchange markets may require flexible measures in individual countries. Therefore, at the time of reviews, which will take place with rather short intervals, we should avoid applying a rigid standard of assessment to all the countries.

Next, let me touch upon the procedural matters. The review of the Madrid Declaration gives us an opportunity to examine the economic conditions of individual economies between Article IV consultations. Thus, it is a useful tool to strengthen the surveillance function of the Fund. In that respect, discussions at the Board may focus on the policies of certain countries. However, I am reluctant to go along with the idea that the Interim Committee should also discuss individual country matters. The Committee is a forum where Governors exchange views frankly on global economic issues. The time available for discussion is limited. The standard for selecting countries, 49 this time, is ambiguous. Considering these points, we should seek a mandate from the Interim Committee that surveillance should be strengthened by more frequent discussions "at the Board" on individual country matters. After that, the Board or management should proceed to take the next step, such as conveying the Fund's message to the respective authorities concerned.

Having said this, I would like to add that the exercise of preparing a one-page report for each country is very useful to sharpen the discussions at the Interim Committee meetings. Therefore, I think it appropriate to submit these reports to the Committee, but only as a basic and fundamental document for lively discussions on global issues at the Interim Committee meetings.

Mr. Shields made the following statement:

I would like to issue a general philosophy on the surveillance process and procedure, and I will comment primarily on the paper that is before us. I found the eight pages constituting the review of progress on the Madrid Declaration to be broadly satisfactory. These pages form a very helpful summary of the key policy steps to be taken in pursuit of the objectives of the Declaration, by a broad segment of the Fund's membership. I also found the attachments on individual countries to be very helpful, both for those inside this institution and ultimately to the Interim Committee.

However, as others have noted, there are problems of consistency, both among the country summaries and, to a lesser extent, between the country summaries in Attachment 2 and the body of the main text. It was quite easy to find examples of this. For instance, the summary on Australia is almost entirely descriptive, and does not contain an assessment about how far Australia has progressed in implementing the Madrid Declaration.

By contrast, if we look at the page for Sweden, we find that it contains a number of policy prescriptions, and it identifies gaps where the authorities have so far failed to implement the Declaration. It is the kind of candid language found in the

Swedish page that this Chair and others have supported in the biennial review of surveillance. So in this respect, if not perhaps in others, I would commend the Swedish model.

There are also places where the review itself raises issues that are not covered in the country pages. As an example, the need for resumed fiscal consolidation in Japan in 1996 is mentioned in the review, but not on the country pages themselves. However, I do not think that these problems with the country pages are sufficient reason to give up on the idea.

It may be very difficult for us to agree on the text of the individual country pages, and on what they should be based, but I do hope we will manage to include them. The reason is that they provide focus to discussions, whether they are on the table or in people's folders, and they do manage to assess actual implementation of the Madrid Declaration at the level where decisions are really made. This is where it seems that surveillance ultimately needs to provide influence.

I accept the fact that potential leaks are a risk, but it is also true that at some stage, in some forum, Ministers must be prepared to be open and honest with each other, even if only on paper, if we are to avoid even deeper risks than those of leaks of information that most informed market recipients would already be well aware of. That does not, of course, invalidate some other complementary approaches to those taken in the individual country pages, perhaps at the regional level.

As to the content of the review itself I have several comments. With regard to the assessment of inflation performance on page 3 of the paper, it strikes rather too complacent a note. It says, and I quote, "Current inflation performance under circumstances of generally robust growth gives particular reason for satisfaction, although vigilance continues to be required to safeguard the achievement of reasonable price stability in most industrial countries." This initial sentence would be better if it reflected the point made later in the paragraph that many industrial countries, with the notable exception of the United States, are still experiencing sizable output gaps that serve to exert downward pressure on inflation. Thus, good inflation performance is not necessarily a reason for satisfaction about policy per se.

Moreover, in reviewing the implementation of the call in the Declaration for the member countries to remove impediments to the free flow of capital, the review states, as it stands, "It is noteworthy that there has been no reversal in the process toward capital account liberalization in the wake of recent turmoil in international capital markets." However, I do not believe that there is, in fact, evidence of any real liberalization. Recognizing that Mexico and its aftermath may have given developing countries reason to pause on capital account liberalization, we feel that, in fact, the review should call for further progress, particularly among developing countries, about which this part of the Declaration is concerned.

In that same respect, the review perhaps acknowledged, as Mr. Kaeser implied, that we are likely in the future to see sharply reduced capital flows to developing countries. The paper could perhaps spell out what policy responses will be needed in those countries experiencing reduced inflows.

I have one comment about the structure of the paper itself. I wonder about the usefulness of Attachment 3. This is one place where we could perhaps reduce the number of pages. The attachment focuses mainly on factual material, and not much on policy prescriptions. But if it is nevertheless decided to retain it, then I would suggest that the information on Naples terms and the Paris Club should not be subsumed under the heading "Aid Policies," but rather there should be a separate heading, perhaps entitled "Paris Club and Naples terms," for the final four paragraphs.

The Chairman remarked that it was important to acknowledge that, since the Madrid Declaration, progress had been made toward addressing the debt problems of severely indebted countries, as seen, for example, in the recently introduced Naples terms of the Paris Club.

Mr. Koissy made the following statement:

The increasing integration of world markets and the complexity of the interactions among them make it important that countries, especially the larger ones, pay more attention to the spillover effects of their policies. In the recent past, and I do not mean in the past two months only, it has become clear that the potential for financial crises to spread cannot be underestimated, thus underscoring the importance of strengthening the Fund's Surveillance exercise. The Madrid Declaration, with its emphasis on a strategy of global cooperation and an outline of policy actions by different groups of countries, is a step in that direction. However, its effectiveness will depend, to a large extent, on the way it is implemented and more generally on how the exercise is carried out.

In this regard, I note that this is the first time that we are carrying out such an exercise and that the present approach may not be the ideal one. This should not, however, be construed as a criticism for the staff, who should be commended for producing this paper in such a short period of time. The appropriate methodology will be laid down as we go along and gain more experience.

As regards the Madrid Declaration for individual countries, while on the whole monetary policy appears to be generally appropriate, as inflation is being contained and real output is growing moderately, fiscal policy in some industrial countries could be tightened. Moreover, it appears that medium-term fiscal targets--and the measures to achieve them--could be better spelled out. Similarly, it does not appear that much progress has been achieved as regards structural reforms, especially in improving the flexibility of the labor market. Although I agree that for the implementation of structural measures the time elapsed since the Madrid Declaration has been relatively short, some of these issues are urgent and require immediate consideration.

On the countries in transition, I welcome the staff paper's optimistic assessment of developments, especially regarding structural reforms. Nevertheless, I agree that the process of market reforms could be accelerated in some of the major countries. Structural reform and institution building will continue to require the full attention of the authorities in those countries.

As regards, developing countries, the situation remains mixed. I note that those countries that were strong performers have maintained their good track record, while the weaker ones continue to suffer from macroeconomic and structural imbalances. For these latter countries, steadfast implementation of strong adjustment programs remain the norm. However, I note that the call of the Interim Committee for better access to industrial country markets for developing countries' exports remains to be heard. Moreover, the adjustment efforts of many developing countries continue to suffer owing to the lack of timely external financial assistance. As a matter of fact, the paper indicates the possibility of a downward trend in external assistance from many industrial countries as well as the inclusion of more stringent constraints and political conditionality to external assistance. These are of serious concern, and will have a negative impact on the adjustment efforts of these countries and make the achievement of sustainable growth more difficult. I would suggest that more emphasis be given to these issues in the report to the Committee.

However, one bright spot that has emerged in the past few months is the implementation of the "Naples terms" regarding the rescheduling and the reduction of the official debt of the poorest countries. Three countries have benefited from those terms and it is hoped that others will receive the same benefits soon.

Recent events have also shown the vulnerability of emerging markets to the moods of investors. Contrary to the optimistic assessment of investors regarding many developing countries' performance, which was translated by a dramatic rise in private investment, the opposite appears to be the case now. Many of those emerging markets are now under tremendous pressure and even countries that are following sound economic policies are finding themselves under severe financial strains due to the exodus of short-term capital. These developments indicate how vulnerable developing countries that open up their markets are to speculators. On this issue, I share the views expressed by

Mr. Daco and I agree that more thought should be given to protecting these economies from these types of shocks.

In the face of these changes, a meaningful role for the Fund in the international financial system takes on added importance. While the present exercise can help in this objective, I have some doubts as regards the present methodology. While the body of the present text appears appropriate, I have the same concerns as do Mr. Shaalan and Mr. Kafka on the inclusion of the country pages. I do not think that the Interim Committee will have the time to study all these cases and make the appropriate individual recommendations. In fact such an approach could be counterproductive, as discussed by the other speakers. I would be in favor of the more general approach, whereby thematic and regional policies are discussed, similar to those on pages 1 to 8 of the report. In this context, I find Mr. Berrizbeitia's proposal quite appropriate and I think it merits further study.

Mr. Wijnholds made the following statement:

I welcome this early opportunity to discuss the implementation of the Madrid Declaration. I also fully support the approach followed, with single country pages serving as background material to help foster a dialogue, hopefully also in the Interim Committee, on the progress achieved so far. As I have no real problems with the methodology, I will focus my remarks on the actual progress made with respect to the Madrid Declaration. Although clearly the jury is still out on the main issues, and I believe the staff has identified them well, some tentative conclusions may be drawn. In addition to the work done by the staff, recent financial market events provide some clues for policy makers as well.

In the trade area, recent developments have generally been promising. The European Union has welcomed three new members, and continues to intensify its cooperation with other European countries, notably those in Eastern and Central Europe. The timely ratification by a broad array of countries of the Final Act of the Uruguay Round could give the new World Trade Organization some momentum right from the start. Trade initiatives in the Pacific Rim and Western Hemisphere regions are positive developments as well. The recent easing of trade tensions is most welcome. It is to be hoped that future disagreements on trade issues could be defused earlier, so that they will be less heated and their disruptive effects on financial markets smaller.

On monetary policy, the preemptive tightening in countries that are furthest ahead in the cycle--the United Kingdom, the United States, and Australia--is essential to contain inflationary pressures, and such policy actions are clearly in accordance with the Madrid Declaration. As the staff rightly observes, more may be needed. I would also point out that most of the countries that raised interest rates in recent months suffered from exchange rate weakness in the recent period of exchange market turbulence, and from a relatively high increase in long-term interest rates earlier. Apparently, anti-inflationary monetary policies still lack full credibility in many countries, despite a satisfactory current inflation performance.

As regards budgetary policy, it is likely that--as in 1994--the cyclical upturn will continue to have a favorable impact on government deficits this year and the next. There is however a real danger that cyclical improvements could weaken support for the more ambitious fiscal policies that are needed in many countries, as the staff emphasizes. Debt ratios are still rising in a number of countries, underlining the urgency of stronger fiscal action. It would be a missed opportunity, indeed, if the current favorable climate were not utilized to reduce structural budget deficits. Here, many industrial countries are, unfortunately, not setting a good example thus far. Countries having programs with the Fund are, not surprisingly, making much larger efforts in the budgetary area. Ukraine's budget deficit, for instance, is projected to fall from 9 percent of GDP--having been 29 percent in 1992--to 3 1/2 percent this year. I should also, I believe, react briefly to Mr. Bergo, who has taken the trouble of singling out my country in his statement. I have no objection to that at all, and I think he raises a legitimate point. I would therefore invite him, on the occasion of the discussion of the Article IV consultation with the Netherlands on May 1, to come back to this point. I think in itself this is a good example of, let us say, calling things by their names, and I have no problem with that.

Based on the staff's review, the progress in implementing structural reforms appears to be mixed. Although not surprising, it is disappointing, because the reduction in high levels of unemployment, especially in Europe, requires more than a cyclical upturn. The present, more favorable, economic environment could ease the pain of structural measures, which inevitably hurt groups in society with specific interests. Implementing a broad program that has "something for everyone" is an additional way to minimize opposition from special interest groups. Through its intimate knowledge of policies in the member countries, the staff is in a unique position to identify successful and less successful reforms in member countries that might contain lessons for others. By highlighting "success stories" the staff can support national authorities' attempts to implement reforms in their own countries. Mr. Al-Jasser has reminded of an exercise held a few years ago.

As to exchange rates, the recent turbulence in exchange markets, which involved substantial appreciations of the yen, the deutsche mark, and several other European currencies--including the guilder--could dampen short-term growth prospects in Japan and in parts of Europe. In the case of the Netherlands, the recent appreciation of the guilder owing to the weakness of the dollar and of a number of European currencies, could--if sustained--reduce economic growth in 1995 by as much as 0.5 percent to 1 percent of GDP. Here I join Mr. Daco in noting that the staff report does not go beyond separate assessments of major countries' policies and does not mention external effects. It is to be hoped that adequate attention will be given to that aspect in the World Economic Outlook.

In conclusion, I consider this a worthwhile exercise, as the first part of a two-track approach to discussing the world economic situation. No doubt, improvements and refinements can be made, but it would be a pity if this effort were to be derailed because of a reluctance by some to undergo a mild form of peer pressure.

Mr. Al-Jasser made the following statement:

Despite the relatively short time period since the adoption of the Madrid Declaration, one can see that progress has been achieved in a number of areas. However, this review has some clear limitations that makes it difficult to come to judgments on a number of issues.

The review indicates that progress on the ratification of the Uruguay Round has been very satisfactory. Indeed, the Final Act has been ratified by countries accounting for over 90 percent of international trade in goods and services. While this development is very welcome, some outstanding issues remain. Against this background, it will be particularly important for member countries to adhere to the spirit and not just the letter of the Uruguay Round agreement, in order to enable all parties to reap the full benefits of the accord.

On other trade-related matters, I particularly welcome the further progress made by members in the acceptance of the obligations of Article VIII of the Articles of Agreement. It is also gratifying to note that there has been no reversal in the trend toward capital account liberalization following the recent turmoil in the international financial markets. I would have like to support Mr. Shields' remarks on the need to enhance and accelerate capital account liberalization, but I feel that it is important to reflect on the lessons of recent development first.

Monetary policies in industrial countries have been, by and large, in accordance with the Madrid Declaration. In some cases, particularly among smaller industrial countries, monetary policy continues to be burdened by fiscal developments. I have little to add to the comments made by the staff. During our discussion on the World Economic Outlook we will have another opportunity to consider the implications of the current monetary stance in the major industrial countries for the global economy as a whole, based on a more rigorous analysis of recent developments.

Progress in fiscal consolidation by industrial countries since last October has been, understandably, mixed. One cannot expect that it would be possible to adjust fiscal policy in such a short period of time in a large number of countries. Unfortunately, most of the countries with the largest fiscal imbalances are the very ones that have made the least progress. Domestic developments in some countries precluded the possibility of formulating sufficiently ambitious fiscal programs. Furthermore, the ongoing debate on budgetary proposals in some other countries also makes it difficult to come to judgments on the adequacy of the future course of policy. For example, it may be too early to make an assessment of future fiscal policy measures in the United States.

It is more difficult to judge progress in the implementation of structural policies. By their very nature, structural policies take significant time to formulate and implement. Nevertheless, it is encouraging to see that some countries have implemented policies aimed at enhancing labor market flexibility. At the same time, it is unfortunate to note that some of the industrial countries with the most urgent need to enhance labor market flexibility have focused recent labor market policies on various budgetary incentives for hiring rather than on removing existing distortions.

Recent developments following the crisis in Mexico have made the task of adjustment and reform in some developing countries, as well as countries in transition, more challenging. Developments in Mexico highlight the importance of policies aimed at enhancing domestic savings and ensuring a sustainable policy stance as well as the pitfalls of relying on short-term foreign debt. Developing countries should be commended for the impressive array of structural reforms that have been implemented in recent years. Delays in policy implementation in some countries are regrettable. Here, again, it may be too early to judge recent structural policy initiatives in developing countries. A more comprehensive analysis, within the context of individual Article IV consultations, would give a clearer and more meaningful picture of outstanding issues.

Turning to the individual country reviews, I found this section of the paper somewhat unwieldy. As I had said earlier, a more thematic approach to this review would have been more productive, and would have allowed a more meaningful comparison of policies across countries. Furthermore, the preparation of these reviews did not benefit from recent consultations with the authorities of individual countries. Mr. Shaalan and Mr. Kafka have already expressed misgivings about the reviews of countries in their own constituencies. I share their concerns fully.

Regarding our report to the Interim Committee on progress in the implementation of the Declaration, I believe that the World Economic Outlook would be a sufficient vehicle, as it has been serving such a purpose all along. However, I could go along on an experimental basis with the preparation of a report by the Board that would cover general themes without references to individual country circumstances. A refined version of the text of the first section of the staff paper could serve as basis for our next discussion of this issue.

Mr. Schoenberg made the following statement:

I find it somewhat difficult to comment on the appropriateness and the effectiveness of the Fund's surveillance in general, as some of my colleagues have tried, on the basis of a paper reviewing progress with respect to the Madrid Declaration. So I shall limit myself today to a more narrow focus and comment only on the approach presented by the staff.

In my following brief remarks, I start from two assumptions: First, notwithstanding the apparent growth orientation set out in the Interim Committee Madrid Declaration, recent developments in the world economy suggest that it might be more appropriate to approach today's subject from a slightly different angle, namely, by recognizing, as Mr. Clark has put it, that, above all, macroeconomic stability is necessary to achieve maximum gains from market-based economies. And, second, it appears to me that among the two main problems facing the Fund's surveillance exercise--namely, how to improve the quality and the timeliness of the Fund's analysis and how to increase the leverage of the Fund in convincing member countries to follow its advice--the latter one is by far the more urgent, requiring improvement.

Starting from these assumptions, I submit that recent developments suggest that an appropriate step to improve our surveillance activity is to move from a general discussion of policies to a more country-oriented approach. I appreciate the staff's attempt to summarize the current economic situation of 49 individual member countries in such a short time span and the condensation of individual member country reports on just one page each.

The critical and fundamental question, however--namely, how many and which countries to include in the exercise--has not yet been answered successfully, to my mind. I wonder whether we should really ask ourselves, or the Interim Committee for that matter, to deal with 49 country reports. Given the most recent developments in international financial markets, I have doubts whether comprehensiveness or completeness should be the adequate guiding principle in selecting countries.

Why should we not concentrate, for instance, on a limited number of major industrial countries with systemic relevance, plus on those countries that the Managing Director referred to recently as potential candidates for emergency Fund assistance, as it appears that this group of countries requires at present more urgent attention and surveillance by the Fund than any other country?

Concentration on a few selected countries would focus and sharpen the surveillance exercise far more effectively than the establishment of a somewhat blurred, new general surveillance exercise established somewhat between Article IV consultations and the World Economic Outlook.

Second, on the focus of the country reports, it appears that the focus on a few major issues in each country is the appropriate approach. In this context, it is probably not an easy task for the staff to strike the right balance between the hard data available, on the one hand, and some discretionary judgment, on the other.

However, how the country reports are formulated raise a number of questions, and in this regard, I cannot be quite as kind as Mr. Autheman promised to be to the staff. As far as I can see, only one country report, Venezuela, starts with the notion that recent policies represent a reversal of previous liberalization reforms in several aspects and are not consistent with the Madrid Declaration, giving rise to the conclusion that, since for most other countries similar characterizations are absent, their policies are consistent with the Madrid Declaration. If this were the case--but probably is not what is meant--those countries could easily be deleted from the report.

Another country page, Turkey, states that further strengthening of stabilization policies supported by effective structural reforms would be needed to meet the objectives of the Madrid Declaration. These two examples appear to point to the need for further clarification of the following questions:

First, what is our understanding and definition of progress toward the implementation of the Madrid Declaration? And, second, what is the definition of consistency or policy in line with the Madrid Declaration given the stated need of further measures mentioned in many country reports?

Third, I have some comments on possible additions to the country reports. I would like to put forward the question, given our most recent experience, whether the country report should not highlight two aspects more explicitly: first, to what extent policy recommendations given by the Fund are shared by the respective authorities, hereby also reflecting the probability of the authorities' implementing the Fund's advice; and, second, whether we might contemplate whether an additional paragraph under the heading "Risks" might be helpful to summarize the current situation and to sharpen the assessment with respect to rising problems in different countries. This could not only expedite the assessment of these different types of risks, but also facilitate an assessment of the adequateness of announced or discussed policy responses.

Lastly, on the issue of actual progress regarding the Madrid Declaration, a number of Directors have referred to the recent exchange rate changes among the G-3 countries, potential policy inconsistencies among them, and the potential impact on other countries. I think that it would be also a useful exercise to study why a number of countries have remained largely unaffected by recent market events, whereas others have experienced strong destabilizing effects.

Mr. Dlamini made the following statement:

The period between the adoption of the Madrid Declaration in October 1994 is relatively too short for either an in-depth analysis or a proper evaluation of performance thus far. Nevertheless, we welcome this initiative as a positive step toward strengthening the surveillance role of the Fund and keeping its membership active in their responsibilities under the Madrid Declaration.

However, there appears to be a need for the Executive Board to agree on the framework for monitoring the implementation of the policy strategy for achieving the objectives under the Declaration. The outcome of such reviews should provide the basis, but not necessarily the format, for the Board's report to the Interim Committee.

In this context, the analysis of each review could be organized along country groupings as presented in the introductory chapter of the present report. Also, in order to avoid the danger of drawing misleading conclusions, appropriate differentiation within each group should be made. A good example is the large disparity in economic performance within the group of developing countries.

While a more in-depth analysis of individual country performance should provide the background information to Executive Directors to the review exercise, the report to the Interim Committee, in our view, should not include the type of one-page individual country notes that accompany the paper before us today. These notes have not told the whole story, and the attempt to defend each country's position may divert attention from the substance of the report.

Finally, I agree with the views as expressed by Mr. Shaalan, Mr. Kafka, and others.

Mr. Lanciotti made the following statement:

I will begin my statement with some general remarks on the Madrid Declaration exercise. In my opinion, its basic objective is for all the policymakers of Fund member countries to achieve a general consensus concerning the need to adopt the basic principles of surveillance in certain key areas of the economy and, thereafter, to take the necessary measures to implement the agreed-upon common strategy. This achievement, as Mr. Bergo observes, is a remarkable fact in itself. The Fund is also required to report to the Interim Committee on the progress made thus far by members in implementing this common strategy. This follow-up by the Fund is a necessary ingredient of the exercise, as it is supposed to exert pressure on policymakers to implement the common strategy adopted in Madrid. On the basis of this analysis about the Interim Committee's expectations, there is no doubt that the survey prepared by the staff is a good starting point.

Both the sample technique and the one-page summaries are useful--and even necessary--practical expedients to help draw the overall picture and single out the relevant country cases to be considered, within the general appraisal, as significant examples.

While the organization of this material is an important preparatory task, basic issues remain concerning this exercise, to which no satisfactory answers have been given thus far, namely, whether the Interim Committee is expected to be involved in discussions concerning individual countries and whether the Interim Committee is the appropriate body to be engaged in such discussions.

If we simply consider the Committee's nature and its traditional working procedures, the answer is clearly negative. Moreover, as the number of countries directly represented on the Committee is a small portion of the entire membership, discussion of individual countries not directly represented could be impolitic and even counterproductive.

This being said, I can not see the value of bringing the one-page summaries to the Interim Committee's attention, while, on the contrary, I can clearly see all the objections that could be raised to this proposal: why just a sample of countries; why those countries; what about the accuracy, updating, and completeness of the reported information; is the observation period too short; what about the consent of the interested authorities; and what about confidentiality?

My opinion is as follows. We should submit a 10-page document to the Interim Committee, very much along the lines of the five general paragraphs already included in the staff paper. The paper should also contain the proposed procedure that we, as the Executive Board and management, intend to implement. That is, the staff will discuss the authorities' views with Executive Directors. The final one-page document will be discussed in the Board, and the outcome of the discussion will be submitted by Executive Directors to their authorities who are members of the Interim Committee, with the necessary analysis and explanations. In the difficult cases, management will have direct contacts with the authorities. In so doing we would keep the exercise within the Board with the blessing of the Interim Committee, to which we would report. This procedure should not be a one-time exercise, but rather one that would be repeated in the future, to include--in principle--all member countries.

Mr. Mozhin made the following statement:

I will be very brief and make only several short points.

First, I find the format of the paper before us, including its Attachment II on individual country matters, quite helpful and suitable to serve as a basis for the forthcoming world economic outlook discussion.

Second, as far as Russia is concerned, practically all the issues raised in the paper before us are going to be addressed in the framework of the prospective stand-by arrangement. Among those issues are the issue of general trade liberalization, the issue of oil trade and oil export liberalization, the issue of "quasi money" promissory notes used by the Government for deficit financing, as well as other issues. By saying this, I am, perhaps, the first one to respond to the invitation by the staff to answer the question whether there are new measures under consideration aimed at addressing issues identified in the staff paper as warranting policy action. At the same time, like all previous speakers, I hesitate to give a direct answer to the third question posed by the staff, namely, in which areas, and for which countries, do Directors consider that progress to date and known intentions for the future fall short of the objectives agreed in the cooperative strategy?

Finally, on a technical point. In the paper before us the numbers in Tables 1 and 2 do not always coincide with the numbers in Attachment II. In some cases this discrepancy is quite substantial. Although in most cases the discrepancy can be explained by different indicators used to measure inflation and fiscal deficit, in my opinion, this is rather inconvenient and sometimes confusing.

Mr. Saito made the following statement:

Only six months have lapsed since the Madrid Declaration and, like other speakers, I believe that it is too early to fully assess progress in relation to the implementation of policies derived from this unique cooperative effort. However, the importance of the agreement reached in Madrid signals the priority the Fund should give to the follow-up report. In this regard, today's discussion takes place in circumstances in which the consensus in the Board for strengthening Fund surveillance, including the role of the Interim Committee, is gaining momentum. Therefore, it is very important for the institution that the Board agree upon the methodology, the contents, and the role of the institution in this cooperative effort.

I will start my comments by first referring to the role of the Interim Committee and later by providing some ideas as to the format and methodology for the preparation of the follow-up report to the Madrid Declaration, as well as some comments on the draft before us.

Regarding the role of the Interim Committee in the effort to strengthen Fund surveillance, I consider that according to its terms of reference the Interim Committee's main function is to advise the Board of Governors on systemic issues. This does not preclude the Interim Committee from analyzing the situation of a particular country or of a particular group of countries with similar problems, as long as they are systemic in nature, affect a particular region, or the membership at large. In the past, for example, the Interim Committee dealt with specific countries when analyzing the "oil shock" or the "debt crisis." By the same token, nowadays higher volatility in exchange rate and globally integrated financial markets pose systemic risks and should be part of the report to the Interim Committee.

So, one might want to ask, where would individual country progress on policy implementation associated with the Madrid Declaration be assessed? I believe that bilateral surveillance should remain first and foremost the responsibility of the Executive Board. In this connection, progress in relation to the implementation of the Madrid Declaration in an individual country should be done systematically within the annual Article IV consultation process. The report to the Interim Committee should be concentrated on assessing in the aggregate how the cooperative effort to implement policies to strengthen global expansion is working and what systemic problems might be affecting its implementation. The report to the Interim Committee should be regionally oriented and, as suggested by Mr. Shaalan, should draw from the Board's review of policy measures taken or considered by member countries based on the summings up of the last Article IV consultation with factual updating as needed.

In relation to the paper presented by the staff, this chair considers that the main body of the report is consistent with strengthening surveillance along the lines described above. However, like Mr. Daco, I believe that the major weakness of the report is that it fails to address the linkages between individual economies in an integrated global market as well as assess the effects and transmission of policy implementation across countries or group of countries. In my view, this is exactly the area where the Fund has comparative advantage. The merger in this institution of a body of highly competent staff and the concentration of one of the most complete data bases on individual countries and on the global economy, makes it uniquely endowed and equipped for an integrated analysis of policy and its interrelation among countries and regions. This should be part of the follow-up report to the Madrid Declaration. This will enhance the role of the Interim Committee in strengthening surveillance in the Fund.

Regarding the staff's assessment of progress for developing countries, I agree with those that view the overall impression given in the individual country descriptions as one of generalized disappointment in terms of macroeconomic stabilization and even structural reforms. The difficulty with these kinds of statements is their potential to mislead rather than to facilitate informed value judgments.

Now, for the record, I would like to make some comments concerning the countries in this constituency, independently of the decision whether or not to include the individual country pages in the report to the Interim Committee.

For example, in the case of Argentina, the shift in the external current account from a surplus of 1.3 percent of GDP in 1990 omits any reference to the strong contraction in economic activity in 1989/90 or the substantial imbalance in the capital account financed through the accumulation of external arrears. The figure provided of 20 percent appreciation of the peso in real effective terms disregards the distortive impact of hyperinflationary conditions on the initial exchange rate chosen for the measurement. In the section on trade policy, a large dispersion in tariffs is implied, while in fact even after factoring in recently announced trade taxes average effective tariffs stand at around 12.5 percent. In addition, the Uruguay Round legislation was not only submitted to Congress but approved in December of last year. The section on macroeconomic stability suggests capriciousness in the relaxation of reserve requirements. Their high initial level allowed for the temporary easing of the liquidity constraint facing the banking system in the wake of the Mexican crisis, without weakening convertibility or the currency board arrangement. Finally, the speed and strength of the fiscal measures recently advanced by the authorities, including congressional approval of tax and other structural reforms, contrasts with the stylized description of macroeconomic developments in Argentina and the conclusion at the end of page 27 that not much progress is likely before the May 1995 presidential elections.

The Fund's contribution to more effective surveillance needs to be based on more distilled conclusions by the Board, recognizing, as Mr. Clark did in his statement, that progress in developing countries has also been substantial, as the case of Argentina exemplifies, to encourage others to initiate comparable policies.

In the case of Peru, the paper describes a series of results but omits to state that all performance criteria and all targets, in particular the fiscal target, were comfortably met in 1994. In this regard, it is worth noting that Peru used less than 50 percent of the privatization proceeds envisaged in the program--$368 million were used while the program envisaged the use of up to $876 million--showing tightening of fiscal policy, not weakening as referred to in the paper. The domestic savings rate increased to 20 percent of GDP while foreign savings remained at 5.5 percent. Similarly, it only states that Peru resumed participation in the Andean Pact with an exceptional status. Peru currently maintains two tariff rates with 99 percent of trade at the lower rate. In contrast, the Andean Pact common external tariff has more dispersion as it consists of four tariff rates. Moreover, in December the authorities announced that they will initiate the process of negotiations with MERCOSUR. Peru's exchange rate system is completely free, while only a limited number of phytosanitary and health-related restrictions remain on the trade side. Finally, some privatizations were delayed due to the April 1995 presidential election, but the structural reforms program, in broad terms, has not been slowed down.

Chile is cited, along with Korea, as one of "the most successful in pursuing the appropriate mix and stance of policies" in the main body of the report. However, this assessment is not consistent with the negative tone of Chile's coverage in Attachment II. One specific point is the treatment of the nonfinancial public sector surplus. It is recorded as a concern because of a downward trend registered during the last two years. A less negative and more balanced approach should note that this surplus (a) has been a very important factor contributing to the "appropriate mix and stance of policy" mentioned above; (b) corresponded to one of only four countries which registered surpluses last year among those included in the review--the other 45 experienced deficits in this sector; and (c) is still large in 1994, amounting to 1.7 percent of GDP. In comparison with the 48 other countries surveyed in Table 2, it is the second largest after Thailand. In the paragraph on structural reform, the privatization of sanitation companies and of the copper company have not faced "political difficulties." In the first case, the Government is making a technical evaluation of different options. On the other hand, the Government has decided that the CODELCO mines exploited until last year will not be privatized during the next five years. New exploitations, such as El Abra, will be developed in joint ventures with private companies that may be majority partners. CODELCO will modernize its current activities before considering privatization options.

In addition, deliberation of 49 individual country reports by the Interim Committee is simply not feasible and could change the nature of the discussion. For all these reasons, we side with those Directors who support excluding the specific individual country assessment of the report to the Interim Committee.

In conclusion, I found the body of the follow-up report useful but would like to see it complemented by an assessment of systemic issues affecting the implementation of policies agreed in Madrid. On the contrary, we believe that the inclusion of individual country reports is counterproductive and should be avoided.

Mr. Geethakrishnan made the following statement:

There are two separate, distinct issues, and Directors need to address the two separately and not mix them up. One is whether or not there is a need for increased, strengthened, enhanced surveillance, and the other is a mechanism for achieving the desired result. I propose to address these two issues separately, but my starting point will be totally different because I want to explain the conclusions I am going to present later.

Two of the 49 countries chosen for individual country reviews in my group are Bangladesh and India. I consulted my authorities in these two countries and, in their assessment, a clear reading of the Madrid Declaration does not require submission of individual country reviews. They have advised, therefore, that there should be only global general reviews on each of the issues included in the Madrid Declaration, and we should do away with this attempt to have individual country reviews.

It is necessary to understand the reasons for this stand, particularly as two countries in my group, India and Sri Lanka, had not raised any objection in the earlier years to publication of box items about them in the World Economic Outlook. After all, the World Economic Outlook is a published document; whereas, at least on paper, the report to the Interim Committee is for a confidential document, limited circulation, and it is not expected to become public.

Why is it that in my group two countries that have even agreed to publication in an open document are now dragging their feet to incorporation of these reviews in the Madrid Declaration? Is it that they have suddenly become very sensitive or suddenly become wiser? I think we need to look into it.

Surveillance is always based in this organization in the Article IV consultation discussions, in the staff and the country authorities, and then in the Board, and the mechanism for conveying concerns, particularly where receipt is concerned, has always been through management, the Managing Director or the three Deputy Managing Directors. This has been the practice.

Discussions on the Article IV consultations all these years have been generally conducted in a gentlemanly, diplomatic manner; the language is very polite. Directors always start by complimenting the staff for the excellent report that they have given, and then compliment the authorities concerned for the little action or no action that they have taken. Directors finish by wishing them well in their efforts, and whatever bad comments they have are all couched in very polite language.

Not that Directors are not aware of the minus points. I am only hoping that management likewise was not too polite in its discussions of serious problems, and that at least the Managing Director was quite candid in his discussion with the authorities on the problem. This has been the past practice, what I would call the pre-Madrid, pre-Mexico era.

But let us look at what has happened in the post-Mexico era. Bangladesh is one of the countries whose Article IV consultation came up in the post-Mexican crisis era. Maybe in our efforts to strengthen the hands of the Managing Director--so that when he goes to the country concerned and talks to the Prime Minister or the President, he can say that even the Board has expressed serious concern--we are now shedding diplomacy somewhat. We are trying to be more candid, direct, and forthright.

In the case of Bangladesh, for the first time Directors called a spade a spade. In regard to some of the other countries that came later, Mr. Berrizbeitia will say that in the case of Venezuela, we did not call a spade a spade, we called it a shovel. In the case of Sweden, or this morning in the case of Italy, we do not mince matters. We would like to be on record saying that where there is a fault, we are willing to highlight it.

It is rather a new thing. I very much welcome it, because there is need for increased and enhanced surveillance, and the only way it can be done is through being very frank in our Article IV consultation discussions. The mechanism can be these Article IV consultation discussions, the country reporting, and as both Mr. Waterman and Mr. Autheman referred to earlier, it can be through the Managing Director--telling the Board whenever a major crisis is anticipated, coming to the Board so that it is able to endorse his view. Thus, when the Managing Director talks to the authorities, he carries the weight of the full Executive Board, not only that of the Managing Director.

I understood Mr. Autheman's suggestion that the Managing Director come and apprise the Board in this way. Whenever the Board has serious concerns, it would like the Managing Director to take it into his confidence so that he may have its full endorsement of the strategy that he is pursuing--being very blunt and frank in discussions with those authorities.

So, in examining the need for enhanced surveillance, the answer is clearly in the affirmative. In examining the mechanism, like Mr. Waterman and Mr. Autheman, I would it to be preserved; namely, that the mechanism for conveying Directors' comments shall be only management. We do not want it to be public knowledge. We do not want it to be in a larger forum.

Having said this, now let us see what exactly has gone wrong with the 49 reports. The 49 draft reports that have been written are like the Article IV summings up in the post-Mexican crisis era. They are fairly violent in the language, quite negative. My Bangladesh authorities had the pleasure of communicating their views to the Managing Director a few days ago and expressed the view that the report was heavily negatively slanted. They did not have the benefit of our prior discussions, either with Mr. Clark or Mr. Daco.

What does Mr. Clark say? The tone of the report is, on balance, negative. What does Mr. Daco say? It seems to me that the tone of the paper is rather negative. Why do three authorities in three different geographical locations come to the same conclusion? That is because the reports are negative in their tone. This is the reason my authorities, who were willing to have reports published in the World Economic Outlook, are today dragging their feet to incorporation of reports in a limited circulation document. It is because today we are shedding diplomacy, we are being blunt, we are being direct. And if that is so, the only way in which we can usefully maintain it is to use the Managing Director as a mechanical convenience.

A very, very pertinent point was made by Ms. Lissakers, of which I think all of us should take serious notice. I hope I am quoting it correctly. She said that we are engaged in international cooperation and not contract enforcement. It is very pertinent. It becomes enforcement if the Managing Director were to say but, look, Country X is like a naughty boy. My staff has told you to do all these things; you are not doing well, so we have circulated to the Board an Article IV consultation report. You are represented through your Executive Director, but still you have not behaved. Now, come along, we will drag you to the next highest forum, namely the Interim Committee. Your finance minister shall come there, stand in the dock, and answer to a group of his own peers.

We use the word peer pressure. But what is very likely to happen is that, the 24 finance ministers being busy people, they come for the meeting and have a great many bilateral discussions. There is a very heavy agenda. In all probability, nobody will even look at these 49 reports. Furthermore, out of the 49 reports, at least 35 of the Governors are not going to be present. The end result will be that the Executive Board will have given 49 reports to the Interim Committee that will just form part of the record. If our objective is to have the reports taken seriously and the Ministers examine each, that is not going to be achieved.

The net result will be that the reputation and standing of the Interim Committee will come down.

Directors will recall what happened in Madrid. We had the SDR/STF issue. We should have settled it among ourselves. We did not, and we did the wrong thing by escalating it to the Interim Committee hoping that they were going to find a solution. Instead, our quarrels merely got escalated to the Governors' level, and all the newspapers and reporting media had a field day about how the Interim Committee lacked cohesion and, for the first time, could not come to a decision.

The Interim Committee is the highest-level forum. We should use it and its full weight for guidance, advice, and endorsement of what we are doing. The moment we take up to the Interim Committee our later-day problems, we are only bringing down the reputation, and the high level will not be able to attend to the day-to-day problems, which are our responsibility. We learned that lesson in the case of the SDR/STF. We must not repeat it by taking surveillance, which is basically our job, up to the higher level.

I submit, therefore, that (a), there is a need for enhanced, increased, strengthened surveillance, and (b), the mechanism should continue to be our Article IV consultation discussions, and the means of taking up the matter with the country should be only management. We will strengthen the hands of management by being forthright in our discussions, and to the extent we are drawn into the discussions more frequently in the problem countries, either through the country discussions or on the special occasions when the Managing Director brings the problems to us, we can strengthen our hands with the countries concerned. Let us not commit the mistake of conveying the feeling that we have failed and are escalating a problem to a higher level, as the higher-level organization will be brought into disrepute because it will not be capable of taking care of the matter.

This is why I would suggest that it is a question of international cooperation. That is the level at which it should be handled in the Interim Committee. If it is a question of contract enforcement, trying to teach somebody a lesson, let us take it up at the Board level. That is what we are paid for. Let us not involve our bosses, the Governors, and bring down the reputation of the Interim Committee.

It is very necessary to note this transition. Mr. Shields referred to the Swedish model. The Swedish model happened because it is the post-Mexican crisis era; the same Swedish model was not there in the earlier years. I am glad that in the post-Mexican crisis era we are vigilant, we are trying to be critical, and we are trying to be direct. When we talk in terms of enhanced surveillance, this is it. We are today being more attentive; let us continue. Let us use the management as the mechanism for taking the matter to the countries; let us not downplay this and shift the responsibility to some other forum. As far as the Interim Committee is concerned, we should report to it on the general matters, give our assessment, and obtain their guidance. Part 1 of the report prepared for Madrid is an excellent start, covering all the general issues and doing a very good job. If the Managing Director wished, we could strengthen it, we could update it, and we could elaborate it. But I do not think we should go beyond that.

The Madrid Declaration has given us the task of enhancing surveillance. Taking it up directly on a country-to-The Fund basis, let us follow the practice of Board discussions on Article IV consultations and then the practice of taking it through management. To the Interim Committee, we will only report at a global level. This is the way in which the world is progressing. These are the plus points and minus points. Will the Managing Director please give us directions on how to further go about it?

The Chairman remarked that he could not subscribe to Mr. Geethakrishnan's description of Fund surveillance as gentle and ineffective prior to the Mexican crisis, and becoming firm and effective only thereafter.

Mr. Geethakrishnan responded that he had drawn a distinction between the summings up of Article IV consultations and the activities of the Managing Director. He assumed that the Managing Director had always been candid in his private dialogue with authorities; his observations on changes in tone and effectiveness had been directed to the summings up. The recent summings up of the Article IV consultation discussions on Sweden, Italy, and Bangladesh illustrated his point.

The Chairman replied that he would hesitate to relate those differences specifically to the Mexican crisis.

Ms. Lissakers considered that bilateral surveillance was primarily the responsibility of the Executive Board and management, and that the Executive Board should play a more active role in following up on Article IV consultations, as had been requested recently for Venezuela. There should be an ongoing dialogue between management and the concerned country, and between the Board and the country. However, the Interim Committee also had a role to play, and she would welcome elaboration in that regard on how Committee members might use the country notes. She assumed that the Committee would not discuss the individual country notes--although that possibility could not be ruled out--but would use the notes rather as background information for its general policy review.

Mr. Schoenberg observed that Mr. Geethakrishnan appeared to be advocating a continuation of current procedures, which, as recent events in the world economy had demonstrated, had not produced the desired results. It was important to look for ways to change existing procedures.

Mr. Geethakrishnan replied that he was, indeed, arguing for continuing with current procedures regarding bilateral surveillance. He saw the Article IV consultations and the dialogue between management and the concerned country as the best forums for addressing problems of individual countries. It was of course possible to enhance surveillance by making the summings up more candid, thereby also strengthening the hands of management in its discussions with the authorities. The Article IV consultations were generally held only every 12-16 months, and he wondered whether it would be possible to have more frequent reviews--perhaps on a quarterly basis--of difficult cases. Another way of strengthening surveillance would be--as suggested by Mr. Autheman--to ask management to keep the Board informed about those cases.

The Chairman remarked that he would take note of the views expressed by the Directors on strengthening surveillance at the staff, Board, management, and Interim Committee levels. He would also note their views on implementation of the Madrid Declaration in preparing the report to the Interim Committee.

Mr. Wei made the following statement:

> We join the previous speakers in welcoming today's discussion on the progress of the implementation of the economic policy objectives set out in the Interim Committee's Madrid Declaration. During the past six months, many changes have taken place in the global economy as the pace of member countries' economic integration has accelerated. It is necessary for the Fund to strengthen its surveillance function, particularly in the context of the turbulent movement of the exchange rates for the U.S. dollar, the Mexican crisis, and the volatile changes in international financial markets. The Interim Committee is especially mandated to examine those issues that have systemic impacts, with the purpose of maintaining a stable international monetary system conducive to fostering a sustainable world economic growth.
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> This being said, it is our view that the importance of a timely review of member countries' progress in the implementation of the policies in the Madrid Declaration cannot be overemphasized, especially the major industrial countries, whose policies have a large impact on the world economy, particularly on the developing countries. The recent Mexican case is a convincing example of how seriously a country, even one such as Mexico, whose economy is larger than many other member countries, can be negatively influenced when capital inflows are suddenly withdrawn.

On economic policies for industrial countries, we agree with the staff that much more needs to be done by these countries in reducing their fiscal deficits, particularly through implementing an effective medium-term strategy, and efforts should also be doubled to reduce unemployment through adopting comprehensive structural reforms for labor market policies.

For the developing countries, we are of the view that it is a matter of urgency for them to pursue and stick to a development strategy that gives priority to social and economic stability. In view of the lessons to be drawn from the Mexican incidence, we fully share the staff view that they must take all necessary adjustment measures to reduce excessive reliance on foreign capital, in particular, the protracted use of short-term capital to offset current account deficits.

For transition countries, we think that stabilizing the economy should be the top priority on their authorities' agenda, taking into account the sharp slide of economic growth and the persistent high inflation, which has caused a serious erosion of living standards for the majority of the population. Social safety nets must be well designed whenever the authorities push forward a reform policy which will have such negative impacts on the poor. This also applies to the developing countries.

Turning to the issue of one-page country reports, I have to say that we have serious doubts about using such an approach to implement the Madrid Declaration, for the following reasons.

First, although the staff has explained the criteria on which the 49 countries have been chosen, like many previous speakers, I am not convinced that the list chosen by the staff is fully justified.

Second, as pointed out by many colleagues, it is simply impossible to present an objective and complete picture of the economic performance for that country in a one-page report.

Third, it is unfortunate that such a one-page report would inevitably be leaked. Thus, the country, if it is a developing country, will suffer in many aspects.

Fourth, much information and data incorporated into these reports were inaccurate.

Therefore, in view of the above, those 49 country reports should not be submitted to the Interim Committee. Instead, we believe that a general presentation, or a presentation of the different groups of countries, is sufficient for the purpose of reviewing the implementation of the Madrid Declaration.

I can support Mr. Shaalan's proposal that in order to truly reflect the economic performance of a country, the only document acceptable to this chair is the summing up of that country's consultation report. That means only the countries whose consultation have taken place over the six-month period selected for this purpose. Up-to-date information could be provided by the country itself in order for the Board to make a better analysis.

In closing, we recognize the need for the Board to strengthen surveillance, and for the Interim Committee to play a more active role in this regard. The approach suggested above for reviewing a country's performance in the context of implementing the Madrid Declaration will enable the Board to draw conclusions along regional and thematic lines as a basis for a report for consideration by the Interim Committee.

Mr. Rouai made the following statement:

We welcome this opportunity to discuss the review of progress under the cooperative strategy agreed by the Interim Committee in its Madrid Declaration. Together with the traditional World Economic Outlook exercise, this review can clearly serve to strengthen the surveillance role of the Fund.

With regard to the content of the report to be submitted to the Interim Committee, we share the view expressed by those Directors who consider that the contribution to surveillance by the Interim Committee would be better served by relying on the kind of reporting presented in the introductory chapter of the staff report, which should be based on recent Article IV consultations. For this exercise to be helpful, we consider also that particular emphasis should be devoted to regional issues and to groups of countries facing similar situations. For example, policy challenges facing oil producing countries, emerging markets, countries affected by capital flows, or heavily indebted countries are more important than the cases of individual countries.

In addition to the remarks made by previous speakers against the presentation to the Interim Committee of one-page country notes, we would like to add the following comments:

First, with regard to multicountry constituencies such as ours, it is difficult for a Governor to be aware of the details of the economic policies of seven countries. It would also seem unrealistic to expect a member of the Interim Committee, in the case of multicountry constituencies, to explain the policy of several national authorities or to make commitments on their behalf.

Second, as country pages are prepared without the benefit of consultations with national authorities or their representatives, they could always be object to challenges. For example, my Iranian authorities consider that in view of the size of their external debt compared with the size of the economy, the external debt is neither large nor constitutes an overhang as characterized by the staff. In addition, the report has mentioned some reform reversals. Considering the fact that there has not been an Article IV consultation with Iran since June 1993, and as no report on the staff's recent mission to Iran has been discussed by the Board, they wonder how the staff reached such a conclusion.

As we are investigating various mechanisms to enhance Fund surveillance, we wonder whether due consideration will be given to the establishment of an evaluation unit.

Finally, the Chairman has just made reference to his direct personal contact with national authorities to convey the views and conclusions of the Board. We support this practice as part of the surveillance process. We wonder whether you could assess the benefit of this direct approach compared with the public involvement of the Interim Committee.

The Economic Counsellor and Director of the Research Department noted that the world economic outlook documents did not attempt to detail the degree of fiscal consolidation appropriate for individual countries; that was a task more suitable for the Article IV consultation reports. The papers for the world economic outlook did contain a table describing the fiscal objectives of various countries; and the question remained whether the level of national savings and the current account position should be taken into consideration when prescribing fiscal objectives, or whether the same objectives should be set for all countries. The one-page country notes were not intended to address specific issues.

The Madrid Declaration contained, inter alia, the point that the Interim Committee would review progress in implementation of the agreed common strategy at its spring 1995 meeting, the Economic Counsellor noted. The purpose of the staff paper and the Board review was to provide the Interim Committee with a basis for its assessment. The Declaration contained a number of specific issues and, at the request of the Interim Committee, the staff had prepared a paper assessing progress on the objectives. There were other issues that were not included in the paper, because they were not relevant to the Madrid Declaration, but undoubtedly, they would also be discussed by the Interim Committee. For instance, the issue of policy coordination among major industrial countries was neither in the staff paper nor in the Madrid Declaration, but it was an important issue that the Interim Committee would probably discuss. Similarly, the world economic outlook discussion and the related summing up would also be taken up by the Interim Committee, as those were matters of considerable importance. Furthermore, there were issues that were in the Interim

Committee's communiqué and were not in the Declaration, but which would also be discussed by the Interim Committee, such as the request to the Chairman of the Interim Committee to continue consultations to resolve the issues relating to the allocation of SDRs. In addition, the financial resources of the Fund, a matter of increasing importance, would, in all probability, be a part of the Committee's deliberations. All those issues were not in the staff paper because they were not relevant to the Madrid Declaration.

Mr. Berrizbeitia observed that, although the phrase "policy cooperation and coordination" was not contained in the Madrid Declaration, it was included in the Interim Committee's communiqué, and was related to the Madrid Declaration, which was, after all, the "Declaration on Cooperation to Strengthen the Global Expansion." One could ask whether "cooperation to strengthen the global expansion" did not also entail reinforcing the Committee's role in promoting policy cooperation and coordination.

Mr. Al-Jasser noted that the word "surveillance" was also not mentioned in the Declaration. The Madrid Declaration was a strategy of cooperation to strengthen the global expansion because--as had been discussed at the last world economic outlook discussion--Directors had been concerned that not all countries would take advantage of the recovery, as had been the case during the previous recovery in the 1980s. It was interesting to observe how the exercise had developed, probably as a result of the events in Mexico. At the Madrid meeting, the focus had been on how to maximize the benefits of the global expansion, and no one had envisaged at the time that the exercise would be related to strengthening surveillance.

The Economic Counsellor noted that the issue of policy cooperation and coordination would be discussed at the Interim Committee, and there would also be a report on surveillance to the Committee. Indeed, the range of issues that would be discussed at the Interim Committee meeting would be much broader than the staff paper before the Board. The staff paper on implementation of the Madrid Declaration was an element of a larger report that would be provided to the Interim Committee. Also, a more complete picture of systemic issues would emerge at the world economic outlook discussions in April. As the events in Mexico had been unanticipated, there was no mention of them in the Madrid Declaration.

It was important to recognize that, although economic policies of large countries had an impact on small countries, the effects could also go in the other direction, the Economic Counsellor considered. Indeed, in recent months, there had been more than one instance of that phenomenon. Although the increase in interest rates in industrial countries was a factor in the developments in Mexico, that was not the only factor. The increase in interest rates should be welcomed, as it was a normal cyclical phenomenon, whereby monetary authorities attempted to moderate business cycle fluctuations. It was necessary to take action early in order to avoid the need for drastic action later. The increase in interest rates in the current cycle had been far lower than in earlier periods; in 1981 the interest rates for U.S. federal funds had been 20 percent and for long-term bonds, 16 percent. One could hope--and expect--that interest rates would not rise that much in the future. Furthermore, the events in Mexico had affected other countries, including industrial countries. The recent pressures in the exchange markets of industrial countries were not unrelated to the developments in Mexico, and there was a concern that the effects of the Mexican phenomenon might either deepen or spread to other developing countries. It was important to take a broader view of the interactions in the world economy, rather than to assume simply that only the policies of large industrial countries affected other countries. For instance, Europe and the world economy had been affected by the events in Italy, which, although large, was not among the three largest industrial countries.

Although the papers on the Madrid Declaration and on the world economic outlook were based on the summings up of the Article IV consultations, the summings up alone were insufficient, the Economic Counsellor observed. For instance, it was necessary to update the information contained in the summing up of the most recent Article IV consultation of the United States, as the Board discussion had occurred in August 1994. The process of updating the analysis and assessments for all countries, in particular for the largest countries, would be a key component of multilateral surveillance by the Board and the Interim Committee in their discussion of the world economic outlook. As the staff had indicated in the Board discussion on surveillance, there should be a mechanism to bring country items to the Board on a more regular basis, and the staff was discussing the kinds of procedures that might be put in place, and would report to the Board on those at the next surveillance discussion. The world economic and market developments discussions were an occasion to review developments in the largest industrial countries, but the staff agreed with the Directors that those discussions were inadequate for an in-depth discussion of policy issues and potential problems and risks facing a number of countries. To provide such analysis, it would be necessary for the staff from the area departments to make presentations to the Board.

The Director of the Policy Development and Review Department remarked that, as most of his comments related to the modalities of surveillance, it would be more appropriate for him to discuss those at the forthcoming Board meeting on surveillance.

The Chairman concluded with the following reflections:

> First, I must thank you for your contributions to this interesting discussion. This exercise adds an important new dimension to our continuing efforts to strengthen Fund surveillance, and I am confident that it will also help to stimulate discussion when the Interim Committee reviews progress in the implementation of the Madrid Declaration.
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> I note that all of us agree on the usefulness of a review of progress in the implementation of this Declaration, not least to provide a basis for a report to the Interim Committee. The review

should stress policy achievements and shortcomings, as well as identify the most critical areas for policy action.

Regarding the individual country assessments, a number of Directors expressed satisfaction with the approach followed by the staff, and with the value of the individual country notes. Nevertheless, a number of other speakers felt that the country notes were too brief to do full justice to the complexities of the problems and policy objectives of individual countries, several of which have not recently benefited from the dialogue with the staff and the Executive Board that is the basic feature of an Article IV consultation.

We all agree that Article IV consultations remain first and foremost the responsibility of the Executive Board, and that the summings up from Article IV consultations remain the basic document in which countries' policies are assessed. For this reason, several Directors preferred a broader and more aggregated approach, such as the one followed in the introductory pages of the staff paper (EBS/95/24, 2/28/95).

On the substance of the policy review, many Directors felt that, given the short period since the Madrid meeting, it was difficult to assess progress in implementing the Declaration, and several Directors emphasized that it often takes time to build the domestic consensus necessary to adopt fundamental and workable policy changes. Nevertheless, I detected a sentiment of disappointment over the degree of progress achieved so far, in terms of both concrete policy action and policy intentions. Certainly, the ratification of the Uruguay Round was a major achievement for the cooperative strategy to strengthen the global expansion. Progress has been mixed in several other important areas, and many challenges remain to allow all countries to strengthen and realize their medium-term potential. This being said, I do not see the need today to try to capture your general remarks on industrial countries, developing countries, or countries in transition. I presume that we can leave this for the summing up of the World Economic Outlook discussion on April 7.

Where do we go from here? Many speakers considered that, while the country assessments had been useful for the preliminary review today, they would not be suitable for submission to the Interim Committee. And they have been very strong on that, a few of them expressing the fear that, if the assessments were to be made public, that could have damaging effects on those countries for which the assessments had been somewhat critical.

If we were to agree with that, one could ask the staff to update and sharpen the introductory pages of the paper in the light of Directors' comments--by incorporating more substance and, possibly, more examples coming from the summings up of our recent discussion--and to prepare a revised text. The individual country assessments would be reserved for the Executive Board's use, and this revised introductory chapter should be available for our consideration at the time of our World Economic Outlook discussion on April 5 and 7. On this basis, the Board would conclude the review, and we would have the basis for a report to the Interim Committee on progress in the implementation of the Madrid Declaration.

I noted that several of you had mixed views on providing the Interim Committee with these one-page documents. I think we should not dwell on this. These documents exist. They are in the hands of the Executive Directors. Indeed, the Executive Directors could utilize them to call the attention of the individual ministers to the prevailing assessment of the situation in the countries, as Mr. Bergo suggested. They will not fail to indicate to ministers that the individual country assessments were neither substantively discussed nor endorsed by the Executive Board.

Looking to future reviews on the conformity of policies to the agreed medium-term strategy, I would say the following. Sometime after the conclusion of this review by the Interim Committee, we should decide how we should conduct similar reviews in the future. For now, I have taken note of the recommendation of many chairs that future reviews should be based on the summings up of Article IV consultations, taking into account the important developments that may have occurred subsequently through an appropriate update that the staff would prepare in cooperation with the Executive Directors.

We must reflect further on the precise modalities we would follow, and we should take advantage of the many constructive suggestions that have been made this afternoon. The type of exercise that we are now trying to implement has the potential to become a periodic fixture of strengthened surveillance, both at the level of the Executive Board and of the Interim Committee. Its fundamental purpose is to strengthen the policy follow-up and, more precisely, to organize, with the guidance of the Interim Committee, the follow-up of the Article IV consultations by the Executive Board. This would be important. This would be an asset to our work, and this would contribute to fostering progress across the membership in the implementation of the cooperative medium-term strategy.

One can interpret from what you have said that this suggestion needs to be made more precise. In that regard, I would like to have an informal discussion with you. I believe that all of us can share the objective, which is to try to achieve the maximum beneficial effects of enhanced surveillance while avoiding possible pitfalls. I think we will be able to do that.

The Chairman noted that the Executive Board could use the country notes in finalizing its review, but the staff would not revise the notes. The staff had been asked to revise only the introductory section of the paper.

Mr. Kafka responded that, in order for Directors to use the country notes effectively, they would have to be substantially corrected.

Mr. Lanciotti observed that, in his statement, he had concentrated on procedural issues; however, he would like to comment on the country notes relating to countries in his constituency and wondered how he could best relay those comments to the staff.

The Chairman remarked that Directors could communicate their corrections to the Secretary for circulation to other Directors, and those would serve as the basis for the Executive Board and Interim Committee's review. He hoped that Directors would focus on important points. Although a number of Directors had objected to forwarding the country notes to the Interim Committee, according to the rules of the Fund, the documents would be available to the Governors.

Mr. Kafka commented that, as the staff might not agree with Directors' comments on the country notes, the Board should perhaps meet for another discussion.

The Chairman replied that Directors would have the opportunity to discuss the matter further.

Mr. Shields said that he too hoped that the one-page notes would be revised, to ensure consistency across the individual items.

The Chairman responded that that could be discussed in the informal meeting. It was important to reach a consensus on the approach to be followed, because the current exercise had the potential of becoming a regular feature of strengthened surveillance.

Mr. Al-Jasser remarked that he understood from the discussion that, as the staff paper had been discussed at the Board, the next step would be for the staff to revise only the introductory section of the paper, and not the individual country notes, for the Board's further consideration. The Executive Directors had the prerogative of sharing the country notes with their respective ministers. He was under the impression that the discussion had moved beyond a consideration of individual notes.

The Chairman noted that he would not like to conclude prematurely the discussion on the one-page country notes, particularly as a number of Directors had expressed strong reservations about them. He would request Directors to communicate any differences of view on the substance of the notes in time for the final discussion of the Madrid Declaration, which would be held in conjunction with the world economic outlook discussion. Directors would have an opportunity to discuss further procedural matters at the informal meeting.

Mr. Al-Jasser considered that it would not be worthwhile to ask the staff to revise the one-page notes, as a number of corrections would be required. In the case of Saudi Arabia, for example, the 1994 data were projections based on the Article IV consultation and bore little resemblance to actual developments in 1994. In his view, the staff's time could more usefully be devoted to revising the introductory pages of the paper for the Interim Committee's review.

Furthermore, in his view, the Chairman had been somewhat definitive regarding the future of the exercise, Mr. Al-Jasser considered. He suggested that the Board revisit the issue after the Interim Committee's spring meeting to discuss the possibility of holding similar exercises in the future, based on Directors' and Governors' experiences. The current exercise had been undertaken on an experimental basis, and it would be important to give further consideration to the results of the experiment before concluding that the exercise should become a permanent feature of the Fund's work.

The Chairman recalled that he had referred only to the potential of the exercise to become a permanent feature of strengthened surveillance.

Mr. Al-Jasser, responding to a query from Ms. Lissakers, reiterated that Executive Directors had the prerogative to share any document that they received with their respective ministers, with the caveat that the ministers were expected to maintain confidentiality of Fund documents.

Ms. Lissakers said that she could not agree with Mr. Al-Jasser that revising the one-page notes would be a waste of time. If the country notes were to be used, it was important that the assessments contained in them be correct. As regards the use of those notes by the Interim Committee, one could envisage a situation where some ministers had been briefed on the country notes, and might comment on them, whereas other ministers would be unable to respond, because they had not been briefed by their respective Executive Directors.

The Chairman suggested that Directors reflect further on the issues before reaching agreement on the approach to be taken.

Mr. Geethakrishnan remarked that, as the Board would be submitting only the introductory section of the paper to the Interim Committee, only that section--and not the 49 country notes--should be revised and updated. At the next Board discussion on the matter, Directors should focus only on the revised text. As regards the one-page notes, he endorsed the suggestion that they should be based on the summings up of Article IV consultations. With respect to the note on India, the contents were substantially different from the Board's assessment at the previous Article IV consultation discussion, and had been written prior to the new budget.

There was a danger that, if ministers cross-examined one another, the dignity of the Interim Committee could be undermined, Mr. Geethakrishnan said. If the intention were to strengthen surveillance, that could be better achieved through the discussions on the occasion of the Article IV consultations.

Ms. Lissakers observed that the one-page country notes were assessments of countries' progress in implementing the specific objectives set out in the Madrid Declaration. It would be useful for ministers to have the individual country assessments prior to their discussion of implementation of the Madrid Declaration. She failed to see how that could undermine the dignity of the Interim Committee, and she doubted whether ministers would interrogate their colleagues. That was not the intention of the exercise.

The Chairman agreed that ministers would certainly not want to embarrass each other by posing questions based on the one-page documents. However, the country notes could provide the basis for an informed discussion regarding progress in implementing the objectives of the Madrid Declaration. The goal was to enhance surveillance, in particular bilateral surveillance, and to ensure that ministers were aware of the conclusions of the Article IV consultations, and that they took appropriate steps. The Interim Committee would take stock of the steps taken in individual countries, and, in that respect, the current exercise could contribute toward strengthening Fund surveillance.

Mr. Schoenberg remarked that he was skeptical about the usefulness of the introductory section alone, particularly as the world economic outlook paper would cover all the issues contained in that section. If Directors were not prepared to assess progress in specific areas, the exercise should be discontinued.

Mr. Kafka observed that Directors did not appear to support the use of one-page notes as the basis for the Board's and the Interim Committee's review, as the notes were misleading. In the circumstances, the best approach might be to ask the staff to update the information contained in the summings up of the Article IV consultations, by bringing recent developments in the country to the Board's attention.

The Economic Counsellor observed that fulfilling Mr. Kafka's request would require staff resources.

Mr. Autheman remarked that some Directors, including Mr. Lanciotti, had offered constructive suggestions relating to procedural matters, but those had not been addressed. He hoped that those proposals would be discussed at the informal meeting.

The Chairman replied that, indeed, they would. He suggested that Directors reflect further on the matter, and he would ask the staff to prepare a revised document for the Board's consideration.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/95/24 (3/15/95) and EBM/95/25 (3/17/95).

4. SOMALIA - OVERDUE FINANCIAL OBLIGATION - REVIEW FOLLOWING DECLARATION OF INELIGIBILITY - POSTPONEMENT

The review of Somalia's overdue financial obligations to the Fund provided for under paragraph 5 of Decision No. 9575-(90/154), adopted October 26, 1990, as amended, is postponed to a date to be determined by the Managing Director, when in his judgment there is once again a basis for evaluating Somalia's financial and economic situation, the stance of its economic policies, and its cooperation with the Fund, and in any event not later than September 18, 1995. (EBS/95/30, 3/10/95)

Decision No. 10926-(95/25), adopted
March 15, 1995

5. APPROVAL OF MINUTES

The minutes of Executive Board Meeting 94/43 are approved.

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/95/34, Supplement 2 (3/15/95) and EBAM/95/39 (3/15/95) and by Advisors to Executive Directors as set forth in EBAM/95/39 (3/15/95) is approved.

7. TRAVEL BY MANAGING DIRECTOR

Travel by the Managing Director as set forth in EBAP/95/17 (3/16/95) is approved.

APPROVAL: July 25, 1996

LEO VAN HOUTVEN
Secretary