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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 96/50

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Executive Board Attendance

P. R. Narvekar, Acting Chairman

Executive Directors	**Alternate Executive Directors**
A. A. Al-Tuwaijri	S. M. Al-Turki
M.-A. Autheman	P. Cailleteau, Temporary
	V. J. Fernández
	A. Galicia-Escotto, Temporary
	C. X. O'Loghlin
	J. A. K. Munthali, Temporary
H. Evans	J. Shields
	A. G. Cathcart, Temporary
	H. B. Disanayaka
	K. Sundara, Temporary
	R. D. Bessone Basto, Temporary
	G. Schlitzer, Temporary
	D. Gotz-Kozierkiewicz
	H. Kaufmann, Temporary
A. Kafka	H. Mori, Temporary
	J. Prader
	V. Rigász, Temporary
	K. Kpetigo, Temporary
	B. S. Newman
	M. Brettschneider, Temporary
	H. Ono
	T. Oya, Temporary
	M. Daïri
C. Saito	J. A. Costa, Temporary
	B. Esdar
	Y. Y. Mohammed
	G. M. Iradian, Temporary
E. Srejber	A. R. Palmason, Temporary
	B. M. Lvin, Temporary
	V. Y. Verjbitski, Temporary
	J.-H. Kang
J. de Beaufort Wijnholds	Y. Margoninsky, Temporary
	Han M.

L. Van Houtven, Secretary and Counsellor
R. Munzberg, Associate Secretary
M. Cuc, Assistant

Also Present

IBRD: M. Farsad, Europe and Central Asia Regional Office. European I Department: M. Russo, Director; H.-M. Flickenschild, M. Huybrechts. European II Department: J. Odling-Smee, Director; O. P. Brekk, M. Castello-Branco, J. Marquez-Ruarte, A. J. Richards, E. van der Mensbrugghe. Fiscal Affairs Department: A. Jaeger, M. Koch. Legal Department: W. E. Holder, Deputy General Counsel; R. Baban, J. Hagan. Policy Development and Review Department: A. Anayiotos, R. Bhatia, S. M. Nsouli, S. Schadler. Secretary's Department: W. Tseng, Deputy Secretary; K. S. Friedman. Southeast Asia and Pacific Department: C. Thimann. Statistics Department: Carol S. Carson, Deputy Director. Treasurer's Department: D. Williams, Treasurer; G. Markosov. Advisors to Executive Directors: R. F. Cippa, K. M. Heinonen, R. Kannan, J. C. Martinez Oliva, M. F. Melhem,Y. Patel, M. Petrie, R. von Kleist. Assistants to Executive Directors: J. G. Borpujari, P. I. Botoucharov, D. Daco, C. Duenwald, J. C. Estrella, D. Giga, C. M. Gonzalez, D. S. Hakura, R. J. Heinbuecher, O. Himani, Huang X., H. Javaheri, P. Jilek, N. Laframboise, H. Paris, N. Prasad, D. Saha, T. Sitorus, Song J., M. Yiu, Zheng H.

1. REPUBLIC OF LATVIA—STAND-BY ARRANGEMENT

The Executive Directors considered a staff paper on the Republic of Latvia's request for a 15-month Stand-By Arrangement in an amount equivalent to SDR 30 million (EBS/96/72, 5/10/96).

The staff representative from the European II Department made the following statement:

The Latvian authorities implemented all the prior actions under the program before issuance of the staff report (EBS/96/72, 5/10/96), with the exception of increasing the excise duties on gasoline and diesel. On May 16, 1996, Parliament agreed to increase the excise tax on gasoline from 4 to 10 santims per liter, effective June 1, 1996, as envisaged under the program. However, rather than raising the excise tax on diesel from 2 to 6 santims per liter also effective June 1, Parliament raised the duty on diesel from 2 to 8 santims per liter, but effective only on January 1, 1997.

Much of the revenue impact from raising the excise duties stems from gasoline. The program envisages that the increase in the excise duty on gasoline will generate LVL 17 million (0.6 percent of GDP) of additional revenue in 1996. The increase in the diesel excise duty was expected to generate total additional revenue of LVL 3 million (0.1 percent of GDP) in 1996. Since 50 percent of fuel excises are earmarked for the Road Fund, which spends only the revenue it receives, the net impact on the basic budget (and overall budget) is only LVL 1.5 million.

Parliament also decided, unexpectedly, to raise the excise duty on alcohol and cigarettes without filter, and impose a new duty on strong beer (alcohol content greater than 5.5 percent). The authorities expect that this measure will offset the impact on the basic budget of the shortfall in tax receipts from diesel in 1996. Two other points are also worth noting. First, overall revenue collections exceeded program projections by LVL 6 million in the first quarter. Second, on account of the higher excise duty, diesel tax revenue in 1997 is now projected to be LVL 2 million more than programmed.

In view of the offsetting measures and developments described above, the staff does not expect the delay in the increase of the diesel excise duty to affect the program adversely.

Ms. Srejber made the following statement:

For my authorities, last year was a difficult one, with banking and fiscal crises before parliament elections in the fall, and the long and difficult process of a government formation. Due to all these factors, the previous precautionary Stand-By Arrangement, approved in April 1995, went off track as fiscal and monetary performance criteria were not met. After these difficulties, in the beginning of this year the new government, which took office at Christmas, came forward with renewed efforts.

My Latvian authorities come with a true understanding that a prudent macroeconomic policy should be complemented with far-reaching structural reforms in order to ensure an environment with broader investment opportunities, which promotes economic growth and improves living standards. The government is placing heavy emphasis on structural changes and is determined to accelerate the privatization process, including all major strategic infrastructure enterprises, and to resolve other strategic issues, such as ownership rights, including land ownership, and further liberalization of foreign direct investment. The government is aware that achieving this breakthrough in the development of the country will require a number of unpopular measures. At the same time, it does not promise the population quick improvements; just the opposite—it warns that a better situation must not be expected in the nearest time and that the success of their efforts, to a large extent, will be determined by the support and confidence of the people.

I will not repeat the points of emphasis of the government program, as it is thoroughly covered by the Letter of Intent and by an excellent staff paper. I will only briefly comment on two areas where the previous stand-by program went off track, namely the fiscal and banking systems, and which are currently in the process of being put on a sound footing to ensure sustainable growth.

Fiscal consolidation was the first and most important task the new government faced. Thus actions were immediately taken to push forward the delayed process of budget approval. Parliament approved a budget with a budget deficit of LVL 59.3 million, or 2.0 percent of GDP, for 1996. However, after studying the situation together with the staff, the government came to the conclusion that, if the stabilization process were not to be compromised, a more suitable deficit target would be LVL 40 million, or 1.3 percent of GDP. Moreover, having said that the improvements were not a matter of one day or one year, but had to be sustainable, the government embarked on efforts to increase revenues by improving the structure of the revenue service and increasing its enforcement powers. Hence, two of the prior actions set in the agreement with the Fund were implemented with a margin; for the first quarter of 1996 the government financial deficit was at LVL 6.13 million, and central government revenues at LVL 170 million, compared to an indicative limit of LVL 15 million for the financial deficit and a floor for central government revenues of LVL 160 million. As a result, market confidence has strengthened, with demand for Treasury Bills increasing and discount rates declining rapidly. However, in order to contain the budget deficit, the expenditures are compressed down to the very minimum. My Latvian authorities recognize that the budgetary problems clearly signal underlying structural bottlenecks, inter alia, in the education and health system. Thus, the government has started negotiations with the World Bank on a Structural Adjustment Loan, and is preparing a Development Policy Program. It would cover management of public resources, including a process of reform of the education and health system; social insurance; sectoral efficiency and productivity; privatization and ownership rights; local administration and finances. Moreover, the government is working together with the World Bank in preparing two loan projects; Welfare Reform and Education System Reform.

Latvia has been through a severe banking collapse and now is coming out of that crisis with a smaller but stronger banking system. Major lessons have been learned. State involvement is decreasing and Latvia can point to a strong privately owned banking system. Most European Union banking Directives have been put into place. Likewise, a regulatory framework using the best from western banking systems has been implemented. Banks are being required to tighten internal controls and to build an effective management system, ensuring the buildup of a system of banks that are serious, not only about survival, but also about prudent and orderly growth.

The banking system has thus strengthened and confidence is returning. Even while accounts of the banking system for the first half of 1995 were closed with a loss, the situation improved notably in the second half of the year, and accounts for 1995 were closed with a profit. Deposits with commercial banks are increasing and speedy development of a secondary market for securities, as well as growing activity in the domestic interbank market, are other signs that domestic banks are increasingly trusted. Net official reserves are growing and now exceed the December 1994, i.e., pre-banking crisis, level. Nevertheless, my Latvian authorities acknowledge that financial intermediation remains low and for further development a lot depends on the pace of privatization, clarifying ownership rights, the legal framework and improvements in the government financial position.

My authorities are determined in their commitment to a market economy, and they are fully aware that the reform process is not going to become easier, since the initial stage, when the actions were quite straightforward, is already over, and now economic policies management is slowly graduating into more of fine-tuning, which requires additional knowledge and skills from the authorities.

In conclusion, I would like to quote the Latvian Prime Minister who said that the State does not consist of one big rock, the democratic state is built by many small bricks. Latvia has to deal with each individual brick which has its own effects and characteristics. All these little bricks that don't fit perfectly together right now in Latvia need to be carefully adjusted and reattached to the wall.

Mr. Margoninsky made the following statement:

Since the last Board discussion on Latvia about seven months ago, the country has overcome the crisis it was in, and the economy has stabilized. In order that the "lost year" of 1995—lost in terms of growth and transition—serve a purpose, the lessons of this episode should be learned. The first lesson concerns the fragility of the transition processes, even in countries that seem to be very much on the right track. The other side of this coin is the need for close monitoring of the transition processes, even when dealing with apparent success stories. A second lesson, and one often addressed when reviewing transition economies, is the close link between macroeconomic stability and structural reforms: in Latvia's case an unreformed banking system jeopardized macroeconomic stability. Combining the two aforementioned lessons yields a third one: only when the structural reform process has been completed, can it be expected that macroeconomic stability will be fully attained.

The 1996 program has objectives of modest dimensions: a modest growth rate, a slight decline in inflation, and a small reduction of the current account deficit. Attaining these objectives necessitated slashing by half the deficit implied by the proposed 1996 budget. The tax package necessary for that has been adopted and now the program's aims are within reach. Even more encouraging are the indications mentioned by the staff, namely that a balanced budget option is to be considered for 1997. Proceeding that way in 1997 will enable the authorities to set an ambitious disinflation target, something that should not be delayed any further. Within the framework of a future disinflationary effort, it could be interesting to identify an optimal exchange rate policy. So far, the pegged exchange rate regime seems to be functioning well and the authorities' willingness to use high interest rates to defend it is reassuring. On the other hand, allowing for a nominal appreciation due to foreign currency inflows accompanying stabilization should not be seen at best as merely a necessary evil, but rather as an opportunity to enhance disinflationary pressures.

The authorities have asked to maintain an international reserves floor that is lower than what is consistent with the monetary program and balance of payments projections, in order to strengthen their ability to defend the exchange rate. The staff's open discussion of this request in their paper is commendable and their arguments in favor of a positive response are convincing.

The authorities' new, foreign investment-oriented, approach to privatization, as reported by the staff, is bold and ambitious. Sticking to it will no doubt pay off in the not so distant future, in terms of growth; but this process might involve—at least in the short run—layoffs and higher open unemployment. Addressing the need to cut the number of employees in the public sector—a need which has already been recognized by the authorities—will have a similar effect. Taking the necessary steps to tackle the higher unemployment will help alleviate the pains involved in an otherwise healthy process.

The severe economic crisis Latvia experienced in 1995 has been overcome by now and the economic program needed to resume a swift transition process has been put in place. The precautionary Stand-By Arrangement is a suitable companion to this program.

Mr. Autheman made the following statement:

I welcome the conclusion of this precautionary stand-by, and appreciate the efforts made by the authorities, with the support of the staff, to address, so far successfully, the banking crisis. Of course, I join the usual recommendation that the tightest the fiscal policy, the best, and, considering the uncertainties, especially in the area of tax revenue, any precautionary measures will be welcome. Indeed, I have to confess that, in spite of the recent measure, I am not yet fully convinced that the targets for tax revenue performance will be achieved. The rapid growth of tax arrears last year is of concern.

I would like to focus my comments on two related issues: competitiveness and exchange rate policy.

I find the box on page 4 on Inflation and Competitiveness quite interesting, although I understand this is a preliminary assessment. I think that this issue needs to be looked at very closely. One must be very careful before concluding that the high rate of inflation, around 20 percent—which shows a disappointing lack of ambition—reflects structural changes in relative prices or lack of appropriate measurement of quality effects. It is not the first time that this eventuality is raised in transition countries, and I see it as a very important area for further work by the region. It may well be that the hypothesis is right, but we must be certain of it before supporting it too warmly.

So I accept the conclusion that the presently rather high rate of inflation has not jeopardized competitiveness. However, looking at this and at the rather high current account deficit, I would be reluctant to support the advice given by the staff that the authorities should be ready to rely on a nominal appreciation of the lat to safeguard inflation, should capital inflows prove overwhelming. First, my expectation is that capital flows in and out; and everything should be done not to change the exchange rate policy in the occurrence of capital inflows. I welcome the recommendation that the authorities should first rely to sterilization, but I think that they should also consider other steps such as raising, possibly creating reserve requirements. These are in my view an effective way for a country like Latvia to compensate for the increasing bank liquidity which would be generated by capital inflows.

Since I remain uncertain about the sustainability of the present exchange rate, and since I think that it is in the interest of the authorities to stick to the exchange rate policy in order to prevent the buildup of inflationary expectations, I would not be willing to support the recommendation of a nominal appreciation.

Mr. Lvin made the following statement:

1995 appears to have been one of the most critical years in the history of the Latvian economic transformation. This history is quite short but very rich in developments that deserve thorough examination both by scholars and policy makers, particularly those in the transition countries. From this perspective, the importance of the 1995 developments in Latvia is to be derived from the observation that it was a sort of test of whether Latvia's reform commitment is really strong enough to withstand its challenges. Today, it would be no exaggeration to state that Latvia has passed this test rather successfully.

The underlying causes of the severe banking crisis which shook Latvia's economic life in 1995 are still to be studied. Apart from the standard explanations related to the lack of necessary skills on the side of those in the banking business, their involvement in too-risky operations, and apparent underdevelopment of the capital base of these banks, it may well appear that the scale and severity of the crisis owes something to a certain overdevelopment of commercial banking in Latvia. This overdevelopment may be traced back to the period of the so-called ruble zone and strongly negative real interest rates in most of the CIS countries, when financial transactions between these countries suffered from extremely long delays. At that time, Latvia's banks enjoyed a very liberal regime in their transactions with foreign currencies, and Riga served as a sort of banking center for the whole post-Soviet community.

Now that these times are over, and some adjustments, though painful as it may be, have to be made, and the Latvian authorities seem to have come to terms with this. Moreover, my impression is that with the immediate consequences of the banking crisis and parliamentary elections behind them, the new government is pushing economic reform even further, thus putting Latvia at the very forefront of transition in many areas.

Some structural issues that deserve particular attention are, first of all, the first steps in pension reform, which, to my knowledge, is still without precedence in the transition countries. Another extremely interesting issue is the very bold, transparent, and innovative approach of the authorities to the process of privatization and foreign investment. I understand that this approach of abolishing almost all barriers to foreign participation is still to be implemented in practice, but I would enthusiastically endorse it. I encourage the staff to render to the authorities all necessary assistance in these areas, for these strides will be monitored closely by all other transition countries.

That such a decisive reform approach sends a very clear message to the market participants, may well be seen in the interest rate developments of treasury bills, as demonstrated in the Chart 8. By April 1996, these rates returned to a secular trend, thus marking the end of market concern, and reducing the Treasury's debt service bill. Of course, this turnaround reflects also the swift reaction of the authorities to the unwelcome fiscal developments. This reaction, as described in the program and the staff report, looks well balanced and fully responsible. The authorities' intention not to raise tax rates, except those on gasoline, and to concentrate efforts basically on the collection issue and on expenditure restraint, should be strongly commended.

Turning to the monetary policy, I can easily endorse the basic stance of the authorities. It seems now that their resolve to defend the exchange rate in the environment of uncertainty helped tremendously to contain the negative effects of the banking crisis, and to prevent any panic. Since the authorities have taken strong measures to curb the budget deficit and the borrowing requirement, I do not see the continuing inflation as a threat to competitiveness or, more generally, as a matter of policy concern. As one can see from Chart 2, the major component of the consumer price index is services rather than goods. Therefore, this phenomenon ought to be explained as, firstly, continuing adjustment of administrative prices, and, secondly, as price convergence in the nontradable sector. All these developments are obviously welcome. Having said this, I do not find really appropriate the wording of paragraph 20 of the program before us, in which the Bank of Latvia is declared to be committed to both exchange rate and price stability. These goals are rather incompatible; after all, 20 percent annual inflation can hardly be called price stability. However, I believe that this is a matter of declaration rather than of the Bank of Latvia's real policy.

I was glad to note the very strong attention the authorities have paid to banking supervision. Now, as the number of banks has decreased and the group of core banks has been identified, this task will become easier to perform. I welcome the provision of having all the core banks subject to audit by internationally renowned companies. The authorities' decision to compensate depositors of the insolvent credit institutions only to the extent that assets are recovered, seems to have great importance also. If carried out without exceptions, and declared as a long-term policy, this approach would result in a steady wiping out of the so-called "implicit deposit guarantees", so potentially harmful for fiscal and monetary policies. More generally, this stance would shift responsibility for imprudent behavior to those immediately concerned, i.e. depositors, borrowers, bank management, and stockholders. In this context, I would urge the authorities to emphasize the strongest possible disclosure requirements as an instrument of banking policy.

Let me now touch upon some external trade issues. The high level of agricultural protection in Latvia is mentioned by the staff and appears to be fully acknowledged by the authorities. I understand that this matter is quite sensitive under the current political settings in Latvia. Nevertheless, I would like to draw some attention to another aspect of the tariff policy, which somehow has been overlooked, although there is, perhaps, less political pressure than there is in the case of agriculture. I mean the general level of protection, which stands between 15 and 20 percent.

Economically, ever since Ricardo it is clear that tariffs hurt only domestic consumers and impede optimal resource allocation, and the best way to deal with protection is to abolish it unilaterally. Politically, it is not realistic that retaining these tariffs would improve Latvia's bargaining position in the course of any future bilateral or multilateral negotiations. From a fiscal point of view, tariff income is too small in Latvia, and can likely to be offset elsewhere. More generally, elimination of nonagricultural tariffs would make the arguments of the agricultural lobby much less defensible, and greatly reduce the incidence of evasion and corruption. And feasibility of such a reform might easily be proved if the authorities look at the experience of neighboring Estonia.

Instead, the authorities appear to have chosen the somewhat unusual way of hiring a private tariff collector. I would appreciate it if the staff could elaborate a little more on this contracting out of tariff collection for I am not familiar with this type of arrangement.

Finally, I was very much encouraged by the intention to have all outstanding gas payments arrears cleared shortly. Latvia itself will definitely benefit from this, as is evident from the smooth relations between the natural gas companies of Russia and Estonia—practically the only country among the Baltic countries, Russia, and other countries of the former Soviet Union having no arrears at all.

With these remarks, I fully support the proposed decision and wish the authorities well.

Mr. Esdar made the following statement:

The Latvian authorities have to be commended for having taken decisive measures to address the problems in the fiscal and banking sectors—problems that caused the previous program to go off track. It is very welcome to learn from the staff report and Ms. Srejber's helpful statement that the authorities have embarked on an ambitious program of prudent macroeconomic policies and structural reform. I am therefore pleased to support Latvia's request for a new Stand-By Arrangement. It is encouraging that the authorities apparently are more interested in the Fund's expertise and advice than in the Fund's financial support.

Since I can support the thrust of the staff analysis and recommendation, I will only comment on three topics which, in my view, deserve special attention.

The inflation targets for this year and the subsequent years do not seem to be very ambitious. In light of the increasing inflation last year and early this year and the expected reduced price pressures from the service sector, I wonder whether a single-digit inflation target should not be aimed at well before 1999. Staff comments would be welcome.

In the same context, we are concerned that deposit interest rates have been negative in real terms for the past several months. Maybe the staff could shed some light on the expected developments of these interest rates—what measures are envisaged to establish their allocation function?

We welcome the staff's recommendation with regard to the exchange rate policy. I was pleased about the staff's considerations on the links between inflation and competitiveness, as shown in Box 1 of the document. A more flexible exchange rate policy in response to strong capital inflows would contribute to constraining inflation, thus reducing the negative effects on competitiveness from an appreciation of the exchange rate. Therefore, I would like to underline the staff's recommendation and reiterate the views expressed earlier by this chair that the nominal exchange rate adjustment would provide the better response to capital inflows than real appreciation caused by inflation. In addition, productivity gains in the course of a successful transformation would make an appreciation of the exchange rate unavoidable in the medium term, anyway, and therefore, in this regard, my policy advice would be somewhat different from that of Mr. Autheman. Monetary policy could be tightened much more in this inflationary environment.

The staff has pointed to the marked increase in dollarization of the Latvian economy. Given the stubbornness of this phenomenon in other countries, the authorities would be well advised to address this problem decisively at an early stage. A strategy based on a sound and convincing fiscal and monetary policies and structural reforms, especially in the banking sector, would certainly be the most appropriate response. Further progress in overcoming the problems of the banking sector in this regard is crucial.

The staff representative from the European II Department said that the inflation target was realistic and appropriately ambitious for the time being. It would be reviewed during the discussions with the authorities in September, at which time a more ambitious inflation target could be considered. Inflation in transition economies was difficult to measure and project because it was not merely a monetary phenomenon. For example, in 1995, liquidity declined by 24 percent, and yet inflation was 23 percent. Major shifts in relative prices, a catch-up of nontradable goods prices, increases in administered prices, excise tax increases, and a lack of productivity growth in the nontradable sector were some of the factors affecting the general price level. In 1996, prices had risen 7.5 percent through April. The excise tax increase would add another percentage point. Furthermore, public utility rates were expected to increase.

Turning to the question of the level of interest rates, the staff representative said that interest rates were determined by commercial banks. As commercial banks did not rely heavily on borrowings from the central bank, the central bank's refinance rate did not have a significant impact on the interest rates charged by commercial banks. There were several factors that explained the relatively low level of interest rates. The exchange rate was fixed—and, hence, the exchange rate risk was small—which meant that Latvia's interest rates closely followed those of its neighboring trading partners. Also, government treasury yields had fallen sharply in recent months because of excess demand. Recent auction bids suggested that demand remained strong despite the yields becoming negative in real terms. Furthermore, commercial banks were reluctant to raise interest rates, because, in light of the experience with the banking crisis in 1995, the public viewed high interest rates as an indication that a bank was in financial difficulty.

Concerning the question of the government contracting out customs collection, the staff representative said that the Latvian authorities had recently decided to hire a well-known British company to assist them in their customs administration and collection.

Mrs. Gotz-Kozierkiewicz made the following statement:

Among the economies in transition, Latvia has been one of those implementing their stabilization and transformation programs according to the standard schedules. After achieving promising results in 1994, a banking crisis and a sharp deterioration in the fiscal performance in addition to pre-election uncertainties became main factors responsible for a halt in economic recovery in 1995. The fundamental difficulties seem to be overcome, according to the current situation assessment and the forecast for 1996. A rebuilding of the somewhat distorted macrostabilization has been going on and the authorities' action reflects a convincing commitment to sound macro stabilization. Thus, the Latvian authorities' request for a 15-month Stand-By Arrangement, covering the program period April 1, 1996 to June 30, 1997 deserves our full support.

What may be of some concern, is the prospects for economic growth in 1996. The monetary policy, determined to a large extent by the consequences of the banking crisis, may not offer a viable basis for financing the economic activity of the private sector. There have been huge discrepancies in short-term deposit and lending interest rates. The short-term deposit rate, substantially negative in real terms in 1995, will be maintained at that negative level also in 1996 (Table 3). This may have i.a. its impact on a higher currency/deposits ratio and, by the same on a lower credit potential of the banking system. The assumption of an increase of domestic credit for the private sector by 4 percent in real terms seems to be strongly desired, nevertheless rather difficult to be accomplished. This concern seems to be even more justified if taking into account a relatively low one-month treasury bill auction rate, which points to expectations of high demand for the government securities.

The banking crisis has probably also increased the probability of further capital outflows at the first sign of new problems. Although the intention of the Bank of Latvia to counteract such developments at an early stage through interest rate increases should be welcome, such a move would severely dampen the already modest economic recovery. It is, therefore, crucial for the authorities to strictly adhere to their financial program in order not to allow any doubt to emerge as regards their medium-term commitment.

A very positive effect for medium-term growth is to be expected from the far reaching legislation on privatization and foreign direct investment. The effects of these structural reforms will be further enhanced by filling the institutional gap in the area of bankruptcy legislation. Although preparation of the draft law has taken considerably longer than envisaged, there is hope that the Parliament will now rapidly finalize the project submitted last month.

In the area of energy pricing, the significant tariff increases should be welcome. A rapid move toward full cost-recovery is desirable both from a fiscal and environmental point of view. This move may, however, not be indifferent on its eventual impact on the inflation rate in the immediate future. Monetary environment, tighter than otherwise, would be helpful in this respect, to contain energy price increase; but at the same time the situation might be more difficult in terms of economic recovery.

Concerning the inflation rate, additional attention should be paid to the relatively high import tariffs in the agricultural sector. The authorities should be encouraged to gradually reduce this high rate of protection. However, the issue would be very difficult to be dealt with, as extremely sensitive for the farmers' lobby.

Mr. Rigász made the following statement:

We welcome Latvia's request for a precautionary Stand-By Arrangement. The economic program for 1996–97 on which the request is based rightly aims at significantly accelerating structural reforms while simultaneously proceeding with stabilization. Since the new government has demonstrated its firm commitment to these policy objectives and to prudent macroeconomic policies, among other things by its decisive implementation of the requested prior actions, we do not hesitate to support the authorities' request for a precautionary arrangement. By expressing its support in this way, the Fund can give an important boost to the ongoing restoration of confidence, at home and abroad, in the Latvian government's intentions and policies.

As with many other Fund programs, the key to arresting the deterioration of the macroeconomic situation in the aftermath of 1995's banking and budget crises was a significant tightening of fiscal and monetary policies. The new government realized this from the very beginning, and its determined efforts have now earned the first pay-offs in the form of lower inflation, a dramatically improved budget performance, and the return of public confidence.

To make these gains more durable, the first and foremost task of the government is now to persevere with its fiscal consolidation. It is therefore encouraging that the authorities' Memorandum of Economic Policies contains a commitment to balance the budget in the medium term. As indicated by Ms. Srejber's very helpful statement, a World Bank Structural Adjustment Loan will play a major role in achieving this goal by eliminating many of the structural bottlenecks that have caused budgetary problems in the past.

In our view, the major challenge to the authorities' goal of putting the public finances on a sound footing will be welfare reform. A simple calculation reveals that in terms of its elderly dependency ratio, Latvia's situation is already as bad as that which the May *World Economic Outlook* predicts for some industrial countries with aging populations half a century from now. With a negative growth rate, presently -1.4 percent according to the last background paper, it seems clear that budget liabilities will soon become a major obstacle to the country's medium-term fiscal viability. We realize that this issue is has been given a high priority in the government's reform agenda, and we accordingly think it deserves more emphasis in the future program reviews.

In the area of monetary policy, no major changes are planned during the program period. Continuation of a cautious credit policy is appropriate, since the economy is expected to emerge only slowly from the recession. The staff rightly notes that the banking system is still fragile and that more time will be needed to restore full confidence in financial intermediation.

We welcome the introduction of new monetary instruments, which will increase the effectiveness of the Bank of Latvia's monetary management.

Continued export growth indicates that Latvia retains some margin of competitiveness despite the continuing real appreciation of the lats. This seems to suggest that structural changes and the move to market mechanisms is more important for the balance of payments than the role played by the exchange rate. The dramatic expansion of privatization and the subsequent efficiency gains will probably preserve Latvia's competitive edge for some time, but this should not induce the government to relax its efforts to bring inflation down to the level of its Western trading partners. We mention this because, like some others, we feel that the 1996 inflation target of 18 percent does not fully match the general ambitiousness of the rest of the program.

With these remarks, we support the proposed decision and wish the authorities all the best in their efforts.

Mr. Munthali made the following statement:

Latvia has made substantial progress in liberalizing the economy and has attained a considerable measure of macroeconomic stability. While there was a promising beginning toward economic recovery in 1994, the combined effect of the weakening fiscal position and the emergence of a banking crisis brought into sharp focus the underlying weaknesses in the economy as growth, which was expected to pick up strongly in 1995, came to a quick halt, while external reserves declined sharply. We share the staff's analysis and the specific policy recommendations. I will, therefore, make a few brief comments since most of the key points have been raised already by previous speakers.

First, we would like to commend the staff for its presentation which highlights two specific issues through the use of boxes. Like Mr Autheman and Mr Esdar we found the discussion on inflation and competitiveness particularly interesting and revealing and we concur with the overall conclusion that the assessment of external competitiveness in Latvia should go beyond the normal calculations based on the use of the consumer price index. While some margin remains, we also agree with the staff that the authorities should closely monitor price and labor cost developments in order to safeguard the country's competitiveness. Whenever crucial issues arise such as those identified in the case of Latvia, the use of such boxes in staff reports could be useful in enhancing the Board's discussion on such matters without compromising on the length of the reports.

Second, we note that the authorities have indicated that they may not effect any purchases under the program. In the continuing political stalemate, the facility should provide an important safeguard while reinforcing credibility in the government's economic adjustment effort. Moreover, if all the measures contemplated under the program are fully implemented, it is likely that business confidence will be quickly restored. As Ms. Srejber has indicated in her eloquent statement, with the strengthened fiscal position together with prior actions, the country has already started to witness a rise in business confidence.

Third, as may be surmised from Appendix III, since November 1991, Latvia has received a fair amount of technical assistance from the Fund in various fields which has undoubtedly helped to impart the necessary tools and skills required to successfully implement these reforms and underpin the transition. The amount of structural reforms introduced so far and the extent of stabilization achieved to date give confidence that the technical assistance has been put to good use and was one of the small but necessary bricks in reconstructing the Latvian economy. Indeed, we believe that, at a time when the intention is not to make purchases under the arrangement, timely technical assistance will be crucial, especially as economic management now moves into a more sophisticated phase of fine-tuning as pointed out by Ms. Srejber. As with the more recent, long-term technical assistance in the field of monetary management, we are confident that most of that assistance was closely linked to the needs of the program.

With these brief remarks, we support the proposed decision and wish the authorities well.

Miss Bessone Basto made the following statement:

We are pleased to see that the reversal of last year's unfavorable economic developments is now evident in Latvia. With the implementation of extensive structural reforms in the banking sector, the authorities were able to improve the soundness of the banking system after last year's crisis and thereby attenuate its disruptive effects on the overall economy. Even though the banking sector remains fragile, enhanced supervision and prudential rules indicate that the government is on the right track to correct this problem. Furthermore, the authorities' recognition that the approved budget for 1996 was inconsistent with their macroeconomic objectives and would lead to increases in government debt to levels that would compromise its sustainability is a major improvement over last year's slippages.

The prompt implementation of additional measures to further reduce the fiscal deficit indicates the authorities' commitment to macroeconomic stability. The government's determination in the implementation of adequate policies was already rewarded by a sharp decrease in interest rates for government securities, which will contribute to alleviate the debt service burden and by greater than projected revenue collections in the first quarter of 1996, according to recent staff information.

The authorities must continue with measures aimed at strengthening confidence in the economy in order to attract foreign investment and allow the development of the private sector. In this context, further progress in fiscal consolidation and the continuation of structural reforms, in particular those aimed at strengthening the banking system and enterprise restructuring, should be considered a priority.

The reduction of the fiscal deficit is needed in order to enhance domestic savings, free resources for the private sector, and reduce pressures on monetary policy. To this end, the strengthening of weak tax collections through either a tax increase or the widening of the tax base is essential. The authorities have already raised excise duties on some products with success.

The staff is justifiably concerned about the high share of wages and pensions as compared with spending on maintenance and investment. The authorities' decision to raise the minimum wage does not indicate a reorientation of spending priorities, even if they are correct about the limited budgetary impact of such a measure. The strengthening of banking supervision, the improvement of the regulatory framework, and bank restructuring measures were instrumental in allowing the stabilization of the banking system following last year's crisis. The success of these actions is evidenced by the decline in the number of problem banks and by the greater compliance with prudential regulations. However, to continue to build on this progress, the bank restructuring and privatization programs should be extended to remaining problem banks.

In addition, as the improvement of financial intermediation depends strongly on the credit risk and recovery of bank lending to the enterprise sectors, progress in enterprise restructuring is also needed. In this context, the privatization program and foreign direct investment legislation introduced during the first quarter of 1996 in allowing the participation of foreign investors were a major improvement. However, further efforts are still needed to address the arrears situation of the energy sector through the implementation of more adequate tariff policies.

Concerning monetary and exchange rate policies, I agree with the staff that, given the present competitiveness levels, a greater upward flexibility of the exchange rate in the event of capital inflows would be preferable to their accommodation.

In conclusion, we consider that the program is strong as it includes a wide and comprehensive range of structural reforms and adequate macroeconomic policies. Therefore, we support the proposed decisions and wish the authorities well in their endeavors.

Ms. Brettschneider made the following statement:

At this stage of the discussion, most of the points I had intended to raise have been made. I will just consolidate a couple of issues.

First of all, I join other speakers in commending the Latvian authorities for the progress they have made in trying to overcome the difficulties that they encountered last year. Based on the strength of the program before us, I can support the proposed decision.

The staff has already addressed the question of the ambitiousness of the inflation target. Following up on that point, we endorse Mr. Autheman's suggestion that more work be done on the issue of competitiveness and exchange rate policy in the region.

Like almost all other speakers, we support the staff's advice to allow for a nominal appreciation of the lats in the event of strong capital inflows.

At last October's discussion of Latvia, there was some discussion of the need for better coordination between the finance ministry and the central bank to develop effective primary and secondary government securities markets and to better coordinate fiscal and monetary policies more generally. Staff comment on whether any progress has been made here would be appreciated.

Latvia is fortunate to have an external debt burden that is still relatively low. We did note in the report, however, the authorities' interest in contracting foreign debt as a means to reduce their debt costs. We fully concur with the staff's response that the only sustainable and reliable way to reduce debt servicing costs would be to cut the deficit in order to achieve both a sustainable level of debt and lower interest rates.

As others have already noted, critical to the success of this program is the rebuilding of the still fragile banking sector, which will be key to instilling confidence in the Latvian economy and encouraging needed investment flows. As outlined in Box 2 of the report, a good start has been made to strengthen the banking sector in the wake of last year's crisis, but much more is obviously needed. Specifically, there is an urgent need to speed up the privatization of Unibank and to address the problems of the Latvian Savings Bank.

Finally, we continue to have very serious concerns about the excessive levels of tariff protection afforded to Latvia's agricultural sector. This has been a recurring issue in our past discussions of Latvia, and we would frankly have hoped to have seen more progress than Box 3 of the report suggests has been made. Given the distortionary impact of this level of tariff protection and the negative signal it sends about Latvia's commitment to an open trade system, we welcome the commitment under the program to reduce average production-weighted agricultural tariff rates by the end of this year and to eliminate remaining quantitative restrictions. We would, however, have preferred that this be made a performance criterion under the program.

Mr. Galicia made the following statement:

During 1995, Latvia faced several internal shocks which lessened its economic position and caused a severe setback in its output growth. A simultaneous emergence of a banking crisis and a slippage in fiscal policy which eventually undermined confidence of the economic agents, is the main explanation of why last's year economic program was deviated from the original projections. The track record shows that indeed Latvia has made a remarkable progress in attaining macroeconomic stability and in its transition to a market economy, but while we concur with the staff that these domestic shocks may be an unavoidable part of the transition process, they also reflect both the fragility of the economy and the serious problems within the baking sector in the country. Fortunately, the authorities have recognized the necessity to continue with solid macroeconomic and structural policies. Therefore, we support the proposed decision and welcome the authority's commitment to put the economy back on track trough an economic program supported by a Stand-By Arrangement.

Since we basically concur with the staff's document, I will be brief and ask one question to the staff. On monetary policy, there is an aspect that needs to be clarified. After the authorities placed a huge amount of treasury bills in the market, the interest rate had been falling sharply, in part due to the renewed confidence in the new economic measures. Because of lower borrowing requirements by the public sector, the nominal interest rates of treasury bills are falling even more. Our main concern is the negative trend that real deposit interest rates have shown practically since December of 1994. The treasury's bill rate is falling so rapidly that by the end of April of this year the real interest rate probably was already negative. The economic program for 1996 projects an improvement in the inflation rate of four percentage points compared with 1995, but the deposit real interest rates are negative in average 10 percentage points since December of 1995. Probably the staff could explain what could be expected from this phenomenon in the long term domestic savings rate and, in particular, the negative impact that this could have with capital flows.

Extending his remarks, Mr. Galicia asked the staff what impact the negative real interest rates were having on capital flows.

Mr. Costa made the following statement:

I want to join other speakers in supporting today's decision on a new stand-by program for Latvia. It is clear now that the 1995 fiscal and banking crises have served to strengthen the authorities' determination to advance in the process of structural reform and fiscal discipline and that this effort deserves the continuous support of this institution. I have only two brief comments, one on the exchange rate system and the other on the appropriate policy response to capital inflows. First, I would like to raise a question regarding the exchange rate system. If the Latvian authorities have chosen to fix the exchange rate why don't they go the whole way and adopt a currency board arrangement. The small margin of flexibility that they allow themselves by not doing so has as a counterpart an increased level of uncertainty that adversely affects the risk factor and interest rates. My impression is that in today's globalized markets the surest way to fix the exchange rate is through a currency board arrangement. Staff comments would be welcome.

Second, since I believe the more likely scenario for Latvia in the near future will be a situation of capital inflows rather than outflows I, as Mr. Autheman, would like to argue against the staff's and Mr. Esdar's advice that a nominal appreciation of the lats would be preferable to allow for higher money growth in those circumstances. Breaking the authorities' commitment to a fixed exchange rate, even if it is to appreciate the currency, would immediately raise the level of uncertainty. I support, therefore, the authorities' intention to resist a nominal appreciation of the currency in the event of large inflows of foreign capital. The authorities should be warned, however, that relying on sterilization is costly and self-defeating. The best policy option would be to increase the soundness of the banking system through appropriate regulation and supervision, so that the foreign resources could be intermediated into the economy in an efficient and responsible way while, at the same time, intensifying fiscal discipline to dampen demand pressures. Of course in all economies, but particularly so in transition ones, the soundness of the financial system is closely linked to that of the enterprises sector. In this regard I welcome the improved bankruptcy procedures that have been announced and the far-reaching privatization program of public enterprises and urge the authorities to hasten the implementation of such program. Efforts to improve tax administration and the enforcement of payments in general are also critical.

Mr. Oya made the following statement:

It is welcome that the Latvian authorities have intensified their economic reform efforts and reached an agreement on a fourth Stand-By Arrangement. I commend the authorities for overcoming difficulties resulting from the banking sector crisis and slippages on fiscal policy by implementing appropriate corrective measures.

As the staff report emphasizes, priority should be given to fiscal consolidation. Given the current sluggishness of the economy, it is crucial to bring down interest rates by reducing the fiscal deficit. In this connection, I welcome the authorities' initiatives to enhance revenue.

Regarding the financing of the fiscal deficit, it seems the authorities have relied to a greater extent than in the past on the issuance of bonds in international capital markets. In a sense this is welcome because it means that Latvia now has full access to international capital markets. However, I would emphasize that too much reliance on the issuance of short-term bonds on commercial terms in international markets would lead to excessive debt servicing costs. Although the authorities seem to be trying to find ways to reduce debt costs, I agree with the staff that more attention should be paid to how to reduce the fiscal deficit rather than how to finance it.

On the structural side, I am pleased to see that significant progress has been made in facilitating foreign investment, which is essential to the achievement of sustainable growth. I would urge other transition countries to follow Latvia's example in this regard.

With these remarks, I support the proposed decision.

The staff representative from the European II Department said that the central bank had effectively encouraged the secondary market in treasury bills by actively participating in the market. It carried treasury bills in its portfolio and was prepared to trade them. That was one reason why the stock of treasury bills had increased significantly in the past few months. However, coordination between the Ministry of Finance and the Bank of Latvia needed to improve, particularly when projecting cash flows and government liquidity requirements.

Concerning the merits of a currency board suggested by Mr. Costa, the staff representative said that there were important reasons why the Bank of Latvia considered the current arrangement appropriate. First, the peg to the SDR had served the country very well. It helped Latvia to restore stability in the foreign exchange market by providing a reliable anchor in the difficult circumstances during 1995. It also allowed for greater flexibility than a currency board would. Furthermore, a currency board arrangement would not allow the central bank to pursue its objective of developing market-based, indirect instruments of monetary policy, which required that the central bank extended credit to the government.

Mr. Shields observed that Directors' concerns that the inflation target was not sufficiently ambitious and the fact that interest rates were negative in real terms pointed to the need for tighter monetary policy.

Ms. Srejber, in her concluding remarks, noted that Directors' exhortations to a small country like Latvia about the need to further reduce its tariffs in agriculture rang somewhat hollow in light of the European Union's own agricultural policy. As concerned the discussion about the monetary policy transmission mechanism, she remarked that it was not unusual that the transmission mechanism did not function effectively in the aftermath of a banking crisis—in that respect, Latvia's experience resembled that of other countries that had gone through similar banking crises. The authorities were committed to solving Latvia's banking problems and improving the effectiveness of the monetary transmission mechanism.

The Executive Board took the following decision:

1. The government of the Republic of Latvia has requested a Stand-By Arrangement for a 15-month period in the amount equivalent to SDR 30 million.

2. The Fund approves the Stand-By Arrangement set forth in EBS/96/72, Supplement 1.

3. The Fund waives the limitations in Article V, Section 3(b)(iii).

Decision No. 11263-(96/50), adopted
May 24, 1996

2. AUSTRIA—1996 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1996 Article IV consultation with Austria (SM/96/104, 5/2/96). They also had before them a background paper on recent economic developments in Austria and selected issues (SM/96/112, 5/13/96).

Mr. Prader made the following statement:

My Austrian authorities broadly agree with the staff's assessment of the major issues confronting Austrian economic policy, and particularly with the staff's views on fiscal consolidation and structural reform. During its March visit to Vienna, the Fund mission team was able to witness the final stage of the authorities' negotiation of the budget package. Despite the usual neutral Fund style in which it is written, and its mention of critical challenges constraining the government's fiscal efforts, the staff report still reflects the unusual optimism and vigorous spirit of reform which permeate the government's adjustment program.

The most salient reference point for putting matters into perspective is the change from last year's consultation, when the staff and many Directors found the planned fiscal adjustment of some 0.3–0.5 percent of GDP "not ambitious enough," and the new two-year budget for 1996–97, which aims at an adjustment almost ten times larger that nonetheless seems to have a reasonable chance of attaining its goal. The critical differences between then and now probably include (I) the clarification of the political situation; (ii) the government's realization that only swift and decisive fiscal adjustment can enhance confidence in Austria's economic policy approach; and (iii) the leadership shown in preparing the program and rallying the coalition partners and the public behind it while maintaining social peace.

The budget package which the government designed in early 1996 and the parliament approved on April 26 is intended to guide an extraordinary effort which should not only bring the budget back to a sustainable level and halt the growth of the debt ratio within a very short time, but should also enable Austria to reach the Maastricht deficit criterion comfortably before the agreed end-1997 deadline. On a current services basis, i.e. assuming no change in policies, the projected budgetary savings (including local and Länder levels of government) will amount to almost 5 percent of GDP.

The announcement of the package puts an end to a period of fiscal developments which had allowed the general government deficit to balloon from a mere 2 percent of GDP in 1992 to over 6 percent in 1995. More than 2 percentage points of the increase in the deficit from 1994 to 1995 are attributable to the costs of EU accession. The markets have been quick to perceive the change in the government's attitude and the seriousness of its commitment to fiscal adjustment, by anticipating the implementation of the consolidation program even before its parliamentary approval: the spreads of some 50 basis points on Austrian over German bonds narrowed dramatically at once and have since then disappeared.

My authorities would take issue with the view expressed in the staff appraisal that "major structural reforms are not part of the present package" by emphasizing that it is not only a first major step toward reversing the growth of entitlements, but also contains significant and lasting structural reforms in the areas of social spending (the introduction of a malus system for early retirement; cuts in social programs like parental leave and nursing care) and civil service reform (e.g, downsizing of public sector employment and containment of the public sector wage bill). As shown in Table 1 of the staff paper, the structural deficit should decline from 6.1 percent in 1995 to 1.6 percent in 1997.

Recognizing that while the rise in the budget deficit was largely due to structural factors, the effect of structural corrections will be lagged, my authorities realize that some revenue increases will also be needed in order to obtain the desired rapid consolidation effects. Their budget program therefore aims at a ratio of two-thirds expenditure cuts and one-third revenue increases. The spending cuts will focus primarily on measures aimed at making administration more efficient and cost-effective and rationalizing and curbing government transfers. The major breakthrough in the budget negotiations was the agreement with the public sector unions on a two-year zero wage round, something unheard of since the post-war reconstruction period. The major changes on the revenue side were the closing of tax loopholes, the elimination of tax exemptions, and the extension of energy taxation to natural gas and electricity. Care was taken to avoid any increase in tax rates, so as not to discourage employment or reverse earlier moves aimed at improving Austria's attractiveness as a business location.

While there is no doubt about the ambitious nature of the budget program and the commitment of the authorities, the program could still be vulnerable to external developments. The budget package was drafted using what were then considered very conservative assumptions about growth and unemployment. During the parliamentary proceedings on the budget, the deterioration of conditions in Austria's main export market, Germany, prompted Austrian economic research institutes to lower their growth projections from 1.5 percent to a range between 0.7 and 1.1 percent. The authorities preferred not to strain the parliamentary process by readjusting the draft budget in the midst of negotiations in response to new economic forecasts, since in any case, the underlying budget assumptions were sufficiently cautious to provide some cushion for adverse developments. However, in the fall the government will conduct a first review of the budget, which will take account of all economic developments up to then. If need be, the authorities will not hesitate to adopt additional new measures at that time to correct potential deviations from the fiscal performance targets.

The authorities appreciate the importance attached by the staff to following up the present adjustment after 1997. They are aware that the momentum of adjustment and reform must be maintained even after the completion of the 1996/97 budget. The present budget is only the first step in a continuous process of reform. The authorities realize that since part of the savings package consists of temporary measures, there is a danger that the structural deficit could widen once more. Indeed, the authorities' attitude toward fiscal deficits has become still more cautious, not only as a result of the internal debate about the causes of and cures for Austria's fiscal problems, but also by participation in the European debate about the required level of fiscal discipline under the European Economic and Monetary Union (EMU). The medium-term forecast made by the WIFO institute estimates that continuation of the deficit reduction measures now agreed upon will keep the deficit at levels below 3 percent of GDP through the years 1998 and 1999.

After having been in approximate balance since the mid-1970s, the current account began to record deficits in 1993. In 1995 the current account deficit doubled to some 2 percent of GDP. Part of this deficit reflected the growing fiscal deficit, including the high net transfers to the EU. It is also partly due to structural problems in tourism, whose traditional surplus has decreased by more than half since the beginning of the 1990s. The current account deficit will shrink in 1996 and 1997 as imports decrease in response to weakening demand, including the planned fiscal adjustment. This improvement in the current account will be somewhat slowed, however, as consumers draw down their high savings in order to maintain their consumption. There is also evidence that recent low interest rates have temporarily encouraged consumers to spend more than they would if rates were higher. Nonetheless, the current account deficit is expected to decrease to 1 percent of GDP by 1997.

Monetary policy continues to be geared to the stabilization of the schilling/deutsche mark exchange rate. In 1995, however, exchange market pressures emerged in the context of difficulties in agreeing on budgetary policies, resulting in capital outflows. Convergence of the macroeconomic fundamentals, the major precondition for continuing this policy approach, has been achieved to a high degree. The tightening of fiscal policy and the low inflation rate (1.5 percent in February) have helped create a climate of declining and very low interest rates. The credibility of Austria's monetary and fiscal policies has been reflected in a dropping of interest rates to a post-war record low and interest rates are now even below German rates at the short end and about even at the long end.

The staff document points out a number of problems with the economic data series provided by the Austrian Statistical Central Office. While some of these problems are due to the transition to EU standards and are also similar to problems found in some other industrial countries, the Austrian government recognizes the validity of these concerns and takes the issue of statistical inadequacies very seriously. Discussions have been held at the highest level with a view to reforming and reorganizing the work of the Statistical Office, with the ultimate goal of enabling it to meet the most demanding international standards in a quick and timely manner.

Mr. Palmason, speaking on behalf of Ms. Srejber, made the following statement:

Most economists would agree that Austria easily qualifies as a relatively well off country in terms of economic and social developments in the past, and that currently she is simply faced with some minor difficulties, similar to those of other mature European economies, which mostly relate to fiscal deficits and structural reform. But what has made Austria unique among other small European economies is the long-established monetary convergence with Germany, while almost one half of the trade has been with that country, and about three fourths with ERM countries. Even more impressive is the high share of manufacturing in exports, contributing 30 percent to GDP and, being the most competitive sector of the economy, it has been an important contributor to the high standard of living and social services in the past. However, as indicated in the staff report, there are some persistent inefficiencies in the economy and, looking ahead, one should not ignore some dark clouds on the horizon which have already contributed to medium term fiscal unsustainability, increasing unemployment, and deteriorating international competitiveness. Perhaps, so far, manufacturing is an exception but, due to deteriorating competitiveness in services and tourism, overall competitiveness has declined.

But why has the Austrian economy performed so favorably, in spite of rigidities in the labor and capital markets, excessive federal and local government involvement in business activity, legal and administrative complications, cumbersome government regulations and strong corporative-like structures? Perhaps the reason is that, although many aspects of domestic economy policy have been restrictive and short-sighted, monetary, exchange rate, and external trade policies have been forward-looking and made up for other less effective weapons in the policy arsenal. While the monetary and exchange rate policies have provided an anchor of stability for investment, production and consumption, trade policy has provided the opportunity to expand the national income. These growth-promoting policies might have been possible as public choice theory would suggest that, when interest groups cover sufficiently large parts of the population, they cannot profit from increasing their share in the national pie through policies that decrease the size of the same pie; instead they only profit in absolute terms if the national pie is expanded. However, it could be argued that Austria would have done even better if the authorities had followed a more market-oriented approach to domestic policy formulation. Likewise, it could be argued that the present anomalies could be corrected by changing the ingredients in the policy mix.

Although the authorities' current fiscal policy efforts seem quite drastic, it appears that the main driving force behind the measures is a one time compliance with the Maastricht criteria in 1997; fiscal objectives after this point are unclear. In the medium-term scenarios analysis, the staff confirms a deteriorating fiscal situation after 1997 in the absence of new measures, since most of the measures taken in the 1996–97 consolidation package will have lapsed by then. A structural deficit of 2.8 percent in 1999 associated with a debt to GDP ratio of 71.4 percent, and a persistent current account deficit of over 1 percent, are clearly not sustainable. Even with additional efforts in 1998, presented by the staff as an additional adjustment scenario of 1.5 percent discretionary measures, a structural deficit of 1 percent, a current account deficit of 0.6 percent, and a debt to GDP ratio of 71.6 percent would remain in 1999. Leaving aside the staff projection that the proposed additional measures would put the debt ratio to GDP on a downward path, it seems that this outcome does not leave much room for automatic stabilizers to function in the short run, and neither do the measures seem likely to contribute much to increased market confidence and growth enhancement in the long run.

While I welcome the current fiscal consolidation efforts, I suspect that they are too piecemeal in nature and not likely to achieve much more than barely meet the fiscal requirement of the Maastricht criteria in 1997. I believe that a more surgical structural reforms approach is needed in order to scale down the inefficient fiscal expansion of the past and to lower the public debt burden, in order to restore Austria's competitiveness and facilitate future growth. While it is important to continue squeezing excessive social expenditures, I believe the way to go forward is to scale down the budget by doing away with activities that can be carried out more efficiently by the private sector. Furthermore, scaling down expenditures leaves room for reducing the revenue burden, which, in turn, would help to win back Austria's recent loss in competitiveness.

To that effect, let me turn to the pension system, which I consider representative for the structural inefficiencies that have contributed to, on the one hand, the deteriorating fiscal situation and increased public debt, while, on the other hand, reduced competitiveness and the incentive to work and, most recently, also reduced incentives to save. Moreover, the fiscal strain on the government and the tax-like contribution strain on employers and employees will escalate over time unless swift and comprehensive action is taken. The staff report confirms that Austria has one of the world's highest pension expenditures in relation to its economic size, to which early retirement and generous benefits contribute. Over the past 25 years, a 25–30 percent expenditure gap in the system has been closed by government transfers and, more specifically, in 1994, the budget transfer amounted to 46.2 billion schillings, which equaled 2.1 percent of GDP. Assuming that the same ratio was to hold in the medium term, one could argue that relieving the fiscal budget of the pension system would suffice to bring the structural balance out of the red. Moreover, a contribution rate of 22.8 percent, and a total social security contribution rate of around 40 percent, is a hefty tax, even among EU members. While the high level of contributions reduces competitiveness directly, for both labor and capital, it also reduces competitiveness indirectly by undermining incentives to work and save. Finally the system is composed of many small occupational units, with varying levels of contribution rates, replacement rates, and deficits, which ultimately leads to high operating costs and other inefficiencies.

In the Board discussion in February on the Fiscal Implications of Aging Populations and Pension Regimes and Savings, I argued in favor of establishing multi-pillar pension systems in industrialized countries. This multi-pillar approach attempts to define, on the one hand, what could be considered the duty of government, namely to redistribute wealth via minimum contribution rates, in order to guarantee a minimum living standard for all and, on the other hand, what should be left to the private sector, namely the savings function, although with regulatory mandate from government, in order to secure full funding, maximum efficiency and minimum distortion. In that regard, I pointed to that the World Bank had already suggested three pillar solutions as a viable alternative to the government operated and unfunded pay-as-you-go systems. I believe my argument applies particularly well in the case of Austrian where the distorting effects of the pay-as-you-go system are very visible. Needless to say, this cannot be done immediately or without some transition costs, but I believe that when weighing the pros and cons of a pension system, more attention should be paid to the effects on savings and, ultimately, growth. But is this important for Austria?

The staff study confirms that Austria has the highest share of gross saving in GDP among EU countries. Moreover, Austria has one of the highest capital/output ratios in the OECD, and investment in the business sector is relatively high. So why should Austria need to save more by implementing a funded pension system? The argument can be supported by a closer look at the composition of savings and investment, which indicates that the savings surplus in the private sector is shrinking, which leaves less scope for financing the public sector savings deficit (SM/96/104, Chart 3). In fact, Austria, with a current account deficit of 2 percent in 1995, is a net importer of capital, which is badly needed to close the public savings gap. One could argue that a mature country like Austria, located at the edge of emerging markets, ought to be enjoying the benefits of being an exporter of capital to countries that pay higher rent than the home market.

The numbers provided by the staff on the international investment position and the international debt position indicate a deterioration between 1993 and 1994. Moreover, the numbers for 1995 indicate a continuation of this trend.

What is noteworthy is that capital imports amounted to 2.5 percent of GDP. Thereof, the largest contributor is placements of Austrian securities abroad due to financing needs of the government. Meanwhile, net purchases of securities by Austrians abroad fell by almost half. At the same time, both foreign direct investment in Austria and investment by Austrian's abroad fell considerably in 1995.

But, given that the, so far, high level of investments is to a large extent borne by private domestic savings, it is important that the high level of private savings be maintained. Conversely, it appears that private savings are shrinking and, at least while domestic demand remains subdued, and as the current fiscal measures start to bite, it appears likely that households will have to reduce their savings further in order to maintain present living standards.

The staff study of the real effective exchange rate index, based on relative unit labor costs in the entire economy, indicates a decline in Austria's competitive position. The study confirms that, from 1990 to 1994, unit labor costs grew by 17 percent and, in the period 1975 to 1994, by an annual rate of 5.5 percent on average. This has been caused to a large degree by segmentation and lack of competition in the economy and, perhaps, created and maintained by the excessive state involvement in many segments of the economy. Furthermore, a rigid wage policy, where wages are collectively negotiated, but with lags between the various sectors, can lead to a spiral of wage increases which do not reflect the competitiveness of individual sectors. To that effect, the competitiveness of the manufacturing sector is being threatened by wage increases in other sectors. Meanwhile, unemployment increases, as the labor market does not allow wages to adjust to competitive levels.

This leads me to my final point on privatization, which might well be the key to improving competitiveness, since more effective employment of capital and labor should aid domestic and export-oriented competition. The OECD concluded in their latest Economic Survey of Austria that privatization is primarily seen in Austria as a way for the government to raise revenue rather than as a means to improve efficiency. This belief is confirmed by the most recent government strategy to rely on privatization to lower the debt to GDP ratio in compliance with the Maastricht criteria. Meanwhile, the federal and local governments are involved with a flora of enterprises in the financial, manufacturing and service sectors to a larger degree than is the case in the neighboring countries. While it is a widely held belief that governments do a poor job of financial intermediation, it is somewhat surprising that a country with a long-established tradition of banking allows government involvement in commercial banking. Likewise, it is surprising that a country with a well-established competitive array of privately operated manufacturing firms supports government involvement in industry. Furthermore, the government has been heavily involved in the housing market over time and, as a result, owns and operates a large stock of real estate in the metropolitan areas, albeit new construction has been reduced considerably in recent years as private ownership of housing has increased. However, it appears that the government is resorting to renewed extrabudgetary support for housing as part of countercyclical measures aimed at increasing activity and employment in construction. Clearly, the government should aim to minimize its involvement in activities that can be more efficiently fostered by the private sector.

Mr. Wijnholds made the following statement:

In line with the staff's assessment, I welcome the firm determination of the new Austrian government to reduce the general government deficit below 3 percent of GDP in 1997—as provided for by the Maastricht Treaty provisions—after the considerable fiscal slippage since 1992. The widespread public and political acceptance of the relatively large amount of consolidation measures—more than 4 percent of GDP—can be attributed to extensive negotiations with social partners in order to present a balanced program to parliament, a strategy the success of which is closely related to the importance of industrial relations in the Austrian economy. The determination of the Austrian government is, among other things, evident from the authorities' unequivocal commitment not to allow any future deterioration of the cyclical component of the general government deficit. Indeed, although the growth forecasts of the staff seem cautious, the expected GDP-growth of 0.7 percent in 1996 requires an increase in private consumption of 0.8 percent, notwithstanding a fall in real disposable income of 0.8 percent. The staff might want to give its view why it expects such a rather abrupt fall in the private savings ratio. Moreover, in my view, an unanticipated noncyclical worsening of the budgetary situation also warrants additional measures, as the consolidation program leaves little room for maneuver. Possible additional budgetary measures should be expenditure-based, as the staff suggests, in order to further enhance market confidence.

Notwithstanding the very ambitious consolidation program, the staff expects the gross public debt ratio to rise until 1998, forcing the authorities to resort to the utilization of privatization receipts so as to comply with the EMU debt criterion in 1998. Although Austria would—in principle—be able to comply with the EMU criteria for public finances by selling off state assets, this strategy would be more convincing if the government also directed its efforts as soon as possible at developing a medium-term fiscal consolidation strategy, aimed at reducing the budget deficit further to figures close to a balanced budget (in line with the current proposals in the framework of the discussion on the stability pact). Indeed, calculations by the staff show that the budget deficit would rise to 3.7 percent of GDP in 1998, if no additional measures were taken. Further fiscal retrenchment would speed up the reduction of the public debt, which currently stands at approximately 70 percent of GDP and is expected to increase to almost 74 percent in 1997 (ignoring stock-flow adjustments). Moreover, this would enhance confidence of financial markets with respect to their assessment of Austria's chances to be part of the first group to join EMU. By reducing the deficit to close to zero, the authorities would also regain room for maneuver, for instance with a view to reducing taxes and the burden of social security contributions in the future. Finally, further fiscal consolidation seems to be warranted with a view to the ageing of the population and the expected growing imbalance between pension expenditures and contributions. Indeed, we agree with the staff than an improved fiscal performance would contribute to improving the current account of the balance of payments, which is currently in deficit after a gradual deterioration since 1992. Indeed, a continuous current account deficit might hamper the credibility of the current hard-currency policy.

I fully agree with the staff's appraisal of Austrian monetary policy, in particular that its hard-currency policy should continue to serve Austria well in the runup to the final stage of EMU. As far as structural reforms are concerned, I consider the staff analysis to be rather limited: it might have been interesting to discuss in some detail the possible effects of EU membership on the structural problems of the Austrian economy. In the context of structural reform, I agree with the staff that some prudence should be considered with respect to wage developments. Wage settlements should not only be based on (relatively high) productivity gains in manufacturing, but should also allow for other, broader indicators of competitiveness. Moreover, wage moderation is needed with a view of reducing unemployment as well as avoiding inflationary pressures. To this end, it is of some concern that unemployment is not exercising much restraint on wages, and perhaps, like in quite a few other European countries it is partly due to the generous welfare system. I therefore agree with the staff that in addition to the proposed measures for enhancing labor market flexibility and for strengthening competition in general, the authorities should undertake significant structural reforms in the area of social spending.

Mr. Daïri made the following statement:

The staff paper refers to Austria as a small open economy with its currency firmly pegged to the deutsche mark. These two qualifications put a heavy burden on the authorities. First, although I would not exactly describe Austria as a small economy, in fact, it could easily be included among the 25 largest countries in terms of overall GDP, it seems to me that the smaller a country is the louder it needs to speak in order to be heard. This applies both to the high level of overall performance it needs to maintain and to the signals it has to give to the international community on its future policy stance. Second, for a "small" economy to successfully maintain a peg to a large economy's currency, it cannot limit its ambition to following the anchor country, it may at times need to outperform it in several ways.

Austria's economic performance over the past 15 years has been outstanding with growth associated with low inflation and unemployment and high rates of savings and investment. This outcome reflected the commitment of the authorities to sound economic policies and a historically unprecedented and unwavering social partnership between the government, employers and labor. The latter, unique feature of Austria's political economy, needs to be maintained and strengthened if Austria is to achieve the objective of being among the first countries to meet the Maastricht criteria.

The recent fiscal consolidation program for 1996–97 approved by the Parliament rightly emphasizes expenditure restraint in view of the already high level of revenue to GDP ratio. I commend the Austrian authorities for their bold action in this respect and for the outstanding performance of its legislative body that enabled the amendment of almost 100 laws within a month or so. However, it is the staff's view that an additional 0.4 percent of GDP adjustment would be needed to meet the 1997 target. The staff rightly indicates the need for fiscal consolidation to penetrate the lower levels of government. Further efforts are also deemed necessary in order to continue the fiscal consolidation process beyond 1997 in view of the expected deterioration in the absence of new measures and the additional pressures on social security stemming from unfavorable demographic trends. I support the staff's proposals in these regards. Furthermore, and given the relatively large debt to GDP ratio, the authorities are encouraged to accelerate privatization in order to enable further debt retirement. Stronger signals to market participants on the authorities' fiscal stance through 1997 and beyond, including provision to face any unwarranted developments, could only strengthen confidence and achieve earlier resumption of growth.

Monetary and incomes policy will need to adequately support fiscal policy in maintaining low inflation and strengthening competitiveness. Efficiency of resource allocation would also be improved by the removal of credit subsidies. Recent elimination of interest rate differentials with Germany is a clear sign of market confidence. This indicator should be closely monitored, and any increase in the differential should be appropriately addressed. Greater labor market flexibility, wage differentiation, and improved productivity are paramount in strengthening competitiveness of the Austrian economy in the context of the present "hard currency" policy.

I am somewhat surprised by the staff's comment that an early widening of the privatization program may result in unfavorable prices if the market perceived that the government was acting under a time constraint. If greater efficiency is the overriding objective of privatization, it would not matter if asset sales would provide somewhat lower yield than expected in an ideal situation. Moreover, such a move could only add to the market perception that the authorities are serious in achieving their goals for Maastricht.

The several references made in the staff paper to existing distortions and rigidities would suggest a much stronger path of structural reform than presently envisaged by the authorities. The staff argues that it is more difficult to reach consensus on structural reforms than on fiscal consolidation. I would not agree fully with this statement since removal of rigidities and distortions would increase potential output and make room for further noninflationary growth and job creation.

To conclude, the Austrian authorities have already taken decisive steps to enhance their chances for first-round participation in EMU. The effort involved in taking the extra step they need to dispel any remaining uncertainty is not beyond their capabilities, particularly if we consider the strong domestic consensus and the outstanding social partnership as well as the authorities' commendable track record of policy design and implementation.

Mr. Esdar made the following statement:

The staff documents for today's discussion are refreshingly concise, to the point and forthright. The same can be said for Mr. Prader's statement, which does not attempt to hide certain shortcomings of economic management.

Concerning fiscal policy, we completely agree with the staff's assessment and the views expressed by Ms. Srejber, Mr. Wijnholds and Mr. Dairi in their respective statements. In this regard we welcome the frank analysis of Mr. Prader in his statement, especially his indication of the firm commitment of his authorities to review fiscal developments in the fall and if necessary adopt additional new measures at that time to correct potential deviations from the fiscal performance targets. The point I would like to stress here is of a more political nature, namely that Austria would have to aggressively cut down its government deficit on all levels with or without the Maastricht criteria as additional benchmarks. The strong increase of the fiscal deficit during the last three years, at a time when the country emerged from the Pan-European recession and recorded healthier growth rates than most other countries in the EU, is clearly and unequivocally unsustainable. Without corrective action the increasing deficits and the rising stock of debt would risk to undermine Austria's hard-won credibility on exchange and bond markets. Austria's membership in the decidedly worthwhile club of first-round participants in EMU would obviously be a sizeable fringe benefit. I have to note, however, in this connection that the fulfillment of the stock-of-debt criterion should not be taken for granted.

The planned privatization of state-owned enterprises is most welcome; for overall efficiency the fact that the privatization receipts could also achieve an on-time turnaround in the development of the debt-to-GDP ratio is again a welcome fringe benefit. As Mr. Wijnholds points out in his statement, and I fully agree with him, this strategy of selling off state assets would be even more convincing if the government also could present a clear-cut and credible medium-term fiscal consolidation strategy, aimed at reducing the budget deficit further to figures close to a balanced budget. These caveats notwithstanding, the Austrian authorities have done a very good job so far, but obviously still have to fully implement many measures and prepare the necessary follow up to significantly reduce the structural budget deficit.

On monetary and exchange rate policy, I do not have much to add to the staff's conclusions. The Austrian authorities have pursued their chosen exchange rate policy with remarkable consistency and success. Austria thereby enjoys amongst the lowest short- and long-term interest rates of all industrialized countries. The somewhat higher inflation rate in Austria compared to Germany is as yet no cause for alarm. Relative price developments should, however, be closely monitored to ensure that Austria's external competitiveness on its main markets does not suffer. This is especially true for the tourism industry, which has encountered substantial difficulties recently, especially on the German market. I might note at this point that the Austrian Tourism Board recently awarded the German Chancellor a medal for more than twenty years of uninterrupted loyalty to his favorite Austrian holiday destination at Lake Wolfgang.

Concerning structural policies, it is indeed gratifying to observe that an economy based on a consensual approach is doing quite well at least relative to others. I agree with Ms. Srejber that forward-looking monetary, exchange rate and external trade policies have played an important role here. I would add, however, the substantial real wage flexibility that surely is crucial for maintaining competitiveness. The virtual absence of strikes, which can be highly disruptive, as several other industrialized countries have experienced during the past few months, is also an important asset. Increased labor market flexibility and greater wage differentiation, at least across sectors, would definitely be welcome.

On the external sector, I do not share the staff's concerns about the current account deficit. Especially in a country with a fixed exchange rate, swings of the current account balance are important shock absorbers for real developments. Austria's current account deficit is largely trade related and not necessarily a bad thing.

All in all, I want to strongly commend the Austrian authorities for their achievements so far and encourage them to continue and, if necessary, further extend their efforts on fiscal consolidation.

Mr. Autheman made the following statement:

I will make three remarks related to fiscal policy, debt, and competitiveness.

The commitment of the Austrian authorities is quite impressive. If my calculations are right, the fiscal measures which the government intends to implement between now and the end of 1997 amount to 5 percent of GDP—4 percent for the central government, which I understand the staff considers well articulated, and almost 1 percent for the local governments, which are at this stage uncertain.

I am ready to believe that this commitment should be taken at its face value and that the stakes for the Austrian government are so high that it is credible. But I would like to express some concern about the consistency of the economic assumptions in the staff report. Mr. Wijnholds already mentioned this, but I find it difficult to believe that a fiscal package of this magnitude will not trigger a recession in a country which cannot expect that interest rates would fall any further.

Of course, the staff is making the assumption that the private saving ratio would fall sharply, which is somewhat strange because the Austrians should expect further tax increases in the future, considering that, in spite of a significant package, the public debt will continue to rise. So I wonder whether the exact cost of its fiscal package has been well assessed, and I would tend to believe that the very unambitious growth targets of 0.7 percent in 1996 and 1 percent in 1997 are still excessive.

My second comment is related to the debt issue. I am concerned about what looks like a lack of concern on the part of the authorities. Indeed, even if they fulfill their fiscal commitment, they will remain off track as far as debt is concerned, since the ratio of debt to GDP will continue to rise around 74 percent of GDP in 1997. And the prospects for further fiscal consolidation are too uncertain at this stage for an expectation of a later decline of this ratio to be made. So I wonder whether this issue is being given enough consideration.

Thirdly, I was wondering how to interpret the staff analysis on the competitiveness of the Austrian economy. The background paper is quite interesting. If I understand the conclusion correctly, one should not look only at the unit labor cost in the manufacturing sector in order to assess the competitiveness of the economy; but considering the share of services, especially tourism, and also the integration of the Austrian economy in the European unified market, which means that the notion of the nontradable sector is less relevant than it was, a broader measure is required. And, indeed, the conclusion is that the Austrian economy has to deal with what looks like an overvalued exchange rate. I have well noted the advice made by the staff that a major change in wage setting would be required in order to prevent the alignment of wages in the service sector with wages in the manufacturing sector. But such a change is not expected.

This issue is quite serious, since the outstanding credibility of Austrian monetary policy makes it an obvious candidate for an unchanged exchange rate. But what will be done at the creation of the Euro will not be corrected later. So I think that there is an important alert in the staff report, and I will look forward to Mr. Prader's indication of how the authorities intend to address it.

Mr. Newman made the following statement:

As a small open economy, Austria has long recognized that its ability to implement effective countercyclical macroeconomic policies is limited. As a consequence, the schilling was tightly linked to the DM 25 years ago, confirming the de facto loss of an independent monetary policy. More recently, the decision to join the EU and meet the budget and debt criteria for participation in monetary union has led to similar consequences for fiscal policy. The economic straitjacket in which policy makers have placed themselves, however, has had benefits in terms of sustained growth, low inflation, improved competitiveness, and elimination of interest premia against DM assets.

The authorities have reconciled themselves to the consequences of the course they have chosen, but it will not be easy to achieve the ends. The pro-cyclical fiscal package that has been adopted to meet Maastricht budget and deficit and debt criteria will remove some 4 to 5 percentage points of GDP from the economy over the next two years, despite current weak growth. The authorities have clearly made the political choice that pursuing countercyclical policies or even allowing the automatic stabilizers to function would not have made much difference in the face of slow growth of Austria's trading partners. With manufactured exports accounting for 30 percent of GDP, and 70 percent of Austria's trade with other European countries also experiencing slow growth, this does not seem to be an unreasonable conclusion. Furthermore, in light of Austria's relatively favorable unemployment rate compared with other European countries, it may have also appeared to be the politically safest course to follow.

However, the slower than anticipated growth in Austria and its trading partners, including an apparent recession in Germany, have clearly increased the stakes. The staff report notes that weaker economic activity than initially anticipated when the budget consolidation plan was adopted will necessitate additional measures to achieve the objectives of the fiscal package. Indeed, the latest downward revisions in European growth forecasts have undoubtedly exacerbated the problem. We would appreciate staff views on the likely magnitude of the additional measures that Austria will need to take to achieve the Maastricht budget deficit goals by 1997.

The Austrian authorities clearly recognize that additional measures are likely to be necessary and that such measures will require even more difficult choices than have already been made in the recent package. As Mr. Prader's statement notes, about half of the fiscal deterioration from 1992 to 1995 reflected the initial cost of EU accession. The remainder, however, was due to longer lasting structural measures, including transfers to cover the growing deficit of the social security funds, the 1994 tax reforms, and increased civil service compensation.

The consolidation package cuts back some of the expenditures, but it appears that about a third of the package reflects temporary measures. We certainly understand the authorities' reluctance to introduce further measures so soon after the Herculean effort to win broad support for the initial consolidation package. Uncertainties regarding economic policies in the larger European countries, the outcome of the current debate on implementation of monetary union, and possible future stability pacts have led to a "wait and see" attitude in a number of countries. Early resolution of these uncertainties could go a long way in providing the confidence necessary to kick-start growth and achieve an economic environment more conducive to meeting the fiscal consolidation objectives that Austria and other EU countries have set for themselves.

Over the longer term, however, additional measures will also be necessary to prevent the structural fiscal deficit from widening. Having come this far, the authorities can ill afford any backsliding. The staff background paper highlights the demographic time bombs facing Austria and most developed countries and the pressing need to come to grips with the projected explosive growth in pension costs. Although Austria's demographic profile is not out of line with other European countries, its current pension system is more generous than most in terms of replacement ratios and early retirement possibilities. Modest pension reforms now can pay big dividends later, but require a political consensus that most of our countries are finding difficult to muster. It may be especially difficult in a country like Austria, where a longstanding social partnership system has played such an important role in the formulation and implementation of policies.

Nevertheless, realities have an unpleasant way of making themselves felt at the most inopportune moments, and it is unlikely that the situation will be any less difficult tomorrow than it is today.

Despite weak economic growth, Austria's unemployment rate compares very favorably with other European countries. The staff report suggests, however, that this is due to factors that may no longer be sustainable, particularly the generous early retirement scheme which encourages the unemployed to leave the job market and immigration policies that provided a safety valve in the past but are no longer politically correct.

Moreover, while the manufacturing sector is highly competitive and growing rapidly, other major employers, especially the tourism sector, are experiencing competitiveness problems and, consequently, reduced employment prospects. In these circumstances, structural reforms to improve wage flexibility would be desirable, even though Austria's system permits greater differentiation than in other European countries.

I would support Ms. Srejber's call for further efforts to reduce the role of the state in the economy. I understand that some of the measures which Austria has used to ease the adjustment to EU membership, such as credit subsidies and extra budgetary support, may be inconsistent with EU rules and will have to be reduced or eliminated. Early action would eliminate undesirable distortions in the economy and reduce potential and actual fiscal costs that are no longer affordable.

I was struck by the comments made by Mr. Autheman and Mr. Esdar which, in effect, raise some issues that will be of particular concern as the EU moves to a common currency. With countries having no possibility to run independent monetary policies and greater constraints on their ability to run countercyclical fiscal policies, this is going to require, obviously, that macro policies be set at the union level and that there are going to be major difficulties in trying to reconcile the inevitable differences that will emerge as a result of that reality.

I hope that my EU colleagues and their authorities will be able to come to grips with this difficulty in an expeditious manner. In particular, eliminating some of the uncertainties that now still exist could make an important down payment in achieving the greater growth that all of us desire.

Mr. Han made the following statement:

Like the previous speakers, I was very impressed by the Austrian authorities' pursuit of the bold fiscal consolidation package in an attempt to ensure a first-round participation in EMU. The objective to drastically reduce the fiscal deficit by 4 percent of GDP, worth about 100 billion schilling, in the period toward 1997 reflects the authorities' decisiveness and the consensus among social partners. In light of the positive market reaction to such a firm commitment, I agree that this objective could be within reach, given the Austrians' past smooth macroeconomic policy performance, dominated by the hard currency policy and relatively good economic fundamentals.

However, the obstacles to achieving this objective should not be ignored. In particular, the sharp deterioration of fiscal deficit in the previous two years, despite the cyclical boom, should warrant a double effort in fiscal retrenchment. In this sense, the staff's careful analysis of the problems ahead and its cautious stance bears merit.

Although the tax rate harmonization—required under the EU accession terms—contributed to the widening of the fiscal deficit equivalent to two percentage points of GDP in 1995, the increase in expenditures, especially the higher transfers to the pension system and the emerging deficit in the lower-level governments, are also important contributing factors. The staff's fiscal comparison study of Austria and the EU countries over the past four years suggests that consolidation efforts in Austria should correct past relaxation of the fiscal stance. Moreover, the recent economic slowdown of its neighboring EU countries will cloud Austria's growth prospects as exports to those countries serve as an economic engine. In a word, the economic environment in the near future will be more challenging than in the previous two years.

Against this background, the success of fiscal consolidation lies crucially in the duration of consolidation measures and the public sector efficiency. In this regard, I am pleased to note that most of the measures in the package are of a permanent nature aiming at cutting social security spending, while others, such as wage restraint, are only valid until 1997. Therefore, like Mr. Wijnholds, I encourage the authorities to develop their medium-term consolidation strategy to embody more permanent expenditure cutting elements. Furthermore, fiscal consolidation in the lower-level governments should also be emphasized as the recent widening of the deficit is traceable to deficit in lower levels. For example, the practice in some localities of replacing house financing with grants should be reconsidered.

In view of Austria's public sector efficiency, the staff has pointed out on page 35 of the background paper several important problems and the distortions in revenue sharing and the transfer system which are likely to lead to overspending. Given the complexities of Austria's revenue sharing system, a comprehensive review to enhance the efficiency in this system should be encouraged in line with developing a long-term fiscal consolidation strategy.

On the external sector, the recent extension of the current account deficit to 2 percent of GDP is a cause of concern. The decline in the tourism surplus and the large transfers to the EU are the main reasons. While the latter is unavoidable, the former is due to a nominal exchange appreciation of the sharing vis-à-vis the Austrians' weak neighboring currencies.

As evidenced by the failure to increase Austria's market share in its trading partners and the small share of services in Austria's exports, the eroding competitiveness in the non-manufacturing sector will require more effort in wage moderation, especially in tapping the wage setting mechanism in the non-manufacturing sectors to their sectoral productivity levels. Moreover, considerable structural reform seems necessary to increase productivity in non-manufacturing sector in the face of intensified competition from Eastern Europe.

Finally, I would like to commend the authorities for their persistent contribution to ODA and appreciate their further efforts in this area. With these remarks, I wish the authorities success in their endeavors to participate in the first round of EMU.

Mr. Schlitzer made the following statement:

The performance of the Austrian economy over the past 15 years or so has been outstanding, characterized by high rates of growth, saving, and investment associated with low rates of inflation and unemployment. This positive outcome is largely the result of the longstanding social partnership between government, employers, and labor in the context of a credible currency policy. This framework, which has served Austria so well, can continue to do so in the future years, provided it maintains flexibility and adapts to changed circumstances.

The main challenges ahead for the Austrian economy are well depicted in the staff paper. In the short run, the main goal is participation in EMU at its inception. In a sense, this is the easiest task given the relatively good initial conditions of the economy. Perhaps the most difficult challenges lie in the long run and relate to the underlying structural transformation of the economy, in particular the need to remove existing inefficiencies and contrasting increasing competition from abroad.

As far as EMU participation is concerned, the firm intention of the Austrian government to reduce the budget deficit to below 3 percent in 1997 is unequivocal. The government's two-year consolidation plan involves indeed a sharp correction in the budget, returning the public finances under control. In this context, the modest rate of economic growth expected for 1996, significantly lower than projected at the time of the plan's approval, should not be a reason for excessive concern. In fact, the plan already makes, as pointed out by Mr. Prader in his informative statement, allowance for adverse developments, and the authorities are firmly committed to take the appropriate supplementary measures where necessary. The composition of the fiscal adjustment also appears appropriate, with the thrust of the correction being on the expenditure side. Besides the fact that the fiscal pressure is already high in Austria, expenditure cuts are necessary to rationalize public transfers and make the administration more efficient.

Our main concern relates to the evolution of the deficit after 1997. The staff projection clearly shows that in the absence of further measures, the deficit will rebound to levels above 3 percent during 1998–99, notwithstanding the favorable phase of the cycle. As we all share the view that fiscal consolidation should continue also under EMU, the momentum of budget consolidation in Austria must be maintained. This also appears necessary in light of the worrisome dynamics of the debt-to-GDP ratio, which is projected to deteriorate gradually beginning with this year. We understand that the Austrian government acknowledges the need to continue the consolidation process in the future and will, therefore, take the appropriate action at the most favorable juncture.

Turning to structural policies, the need to remove some inefficiencies in the economy and enhance its competitiveness is unquestionable. The statistical evidence provided in the background paper points convincingly to a gradual erosion of the overall competitiveness of the Austrian economy. This casts a shadow on the prospects for the country's future export performance and the possibility to balance its current account.

The authorities should act on several fronts. One is toward the further reduction of the weight of the public sector on GDP through privatization of public-owned enterprises. There are indeed a number of sectors, from telecommunications to banking, which would greatly benefit in terms of efficiency from the involvement of private capital. A second should be toward a coordinated effort to increase the flexibility of the labor market. In fact, the new challenges posed both by the opening up of Eastern Europe and the EU membership call for an intensified transfer of resources, most notably labor, between sectors, firms, and occupations. Therefore, a number of rigidities, such as the remaining obstacles to part-time employment and flexible work time, cannot be maintained any longer in the present context.

The Austrian government should also address the sectoral dimension of the competitiveness issue. In fact, while unit labor costs and productivity growth in manufacturing are adequate, the same is not true for the service sector, which has been sheltered by high barriers to entry and lack of competition. This is a feature of other European economies—Italy, for example.

The fact that wage settlements in manufacturing set the pattern for wage increases in other less dynamic sectors of the economy also helps explain the gradual weakening of the competitiveness capacity of the Austrian economy. Thus, it is important that the productive potential of the service sector be enhanced through increased competition and greater wage differentiation.

Finally, concerning the statistical inadequacies pointed out by the staff, we do acknowledge the difficulties in reforming the domestic statistical system and praise the Austrian government for its effort toward meeting the EU standards.

Mr. Iradian made the following statement:

The Austrian economy has so far been among the better performers in Europe. Over the past eight years, growth remained above the EU average, inflation fell to its lowest level, and the unemployment rate, although recently rising, is remarkably low by European standard. While the budget target for 1995 was not met, it appears that transient factors contributed to the slippage during the year. Since I am in broad agreement with the thrust of the staff appraisal, I will limit my comments to some aspects of fiscal and structural issues.

I am encouraged to note from Mr. Prader's helpful statement that the authorities aim at bringing down the general government deficit by 1997 to a level consistent with the 3 percent deficit ceiling set out in the Maastricht treaty. If I correctly interpret page 14 of the background paper, the fiscal consolidation package is consistent with the stated target and contains significant and lasting structural reforms in the areas of social spending and civil service reform. The target is also appropriately ambitious given that the structural deficit is expected to narrow by 4.5 percent of GDP within two years. In spite of these favorable policy developments, further efforts are needed to continue the fiscal consolidation process beyond 1997, particularly in view of the future challenges posed by an ageing population. Given Austria's comparatively high tax burden this would be best pursued primarily through further expenditure restraint. In this regard, a change in the composition of the government spending, with a relative shift away from social expenditures, would be appropriate.

While the challenges posed by European integration have provided a strong momentum to the structural reforms already undertaken in the past several years, progress in certain areas remains limited. In this respect, like Mr. Wijnholds I would encourage the staff to address the possible effects of EU membership on the structural problems of the Austrian economy.

In labor market, there is a need for more flexibility in the process of setting wage increases to take account of sectoral and regional differences as well as skill differentials. Action to reduce undue incentives for early retirement is also called for in order to raise labor force participation, and ensure the longer-term viability of pension schemes.

As for structural reform in the credit market, I encourage the authorities to continue reducing credit subsidies, which distort the allocation of resources, impair the functioning of the monetary transmission mechanism, and impede the development of the domestic capital market. Could the staff update us on any reform measures that have been introduced in this area?

With respect to the medium-term outlook, I am less pessimistic than the staff and Mr. Autheman on the growth prospects for next two years, which is projected at only 0.7 percent (the lowest among EU countries). The recent significant fall in interest rates combined with the confidence effects of the credible fiscal measures, as reflected in lower long-term interest rates than in

Germany, should partly offset the short-term loss in output that is associated with the fiscal retrenchment.

Finally, I would like to commend the Austrian authorities for their continued sound economic policy and wish them continued success.

The staff representative from the European I Department said that the current economic setting was favorable; growth in Europe was expected to accelerate in the latter part of 1996, while domestically inflation was low, wage contracts showed restraint, and business profitability was high. There were several additional considerations that supported the projected growth for Austria. First, Austria would likely benefit from recent tax reductions in Germany. The tax cuts affected primarily lower income groups that typically accounted for a large share of Austria's tourism. Second, economic prospects for 1996–97 had improved because the decisive way in which the Austrian government had adopted, and was now beginning to implement, its fiscal adjustment program was likely to bolster business and consumer confidence. Finally, past experience in both Austria and Germany (e.g., during the 1992–93 recession) suggested that household savings rates tended to fall during economic slowdowns, thus helping sustain consumer spending. All these factors had been taken into account in arriving at the growth assumptions for 1996 and 1997.

Mr. Prader said that fiscal consolidation measures were not expected to exert a strong negative influence on Austria's short-term growth. The reduction in households' disposable incomes would affect spending on imported goods and services, particularly tourism, rather than spending on domestic output. Not only would domestic growth prospects remain relatively unaffected, but the current account would improve as well. Moreover, it was important that the budgetary consolidation was successfully implemented despite any risks to short-term growth prospects. The credibility of the Austrian model and its future depended on the country's ability to join EMU on schedule.

The centralized wage policy had certain limitations, Mr. Prader conceded. While it helped maintain the international competitiveness of the manufacturing sector, in some instances it affected negatively the competitiveness of sectors with relatively slower productivity growth. However, the present problems in tourism could not be attributed to the centralized wage policy. Rather, it was the significant currency devaluations in countries competing with Austria for tourist dollars that had reduced Austria's relative attractiveness as a tourist destination. Looking into the future, Austria's high degree of real wage flexibility should serve it well in EMU, where the arsenal of macroeconomic policy tools available to individual countries would be severely limited.

Mr. Wijnholds remarked that a fall in the private savings ratio, assumed in the staff projections, could explain why smaller open economies were sometimes able to withstand external shocks relatively well—for example, in 1993 both Austria and the Netherlands had avoided the recession that had hit other European countries.

Mr. Daïri noted that a recent assessment prepared by the European Union had not included Austria among the first round of participants in EMU. Were there any measures that Austria could take to qualify for early membership in monetary union?

The staff representative from the European I Department stated that the staff calculations indicated that, under the growth assumptions for 1996 and 1997, additional measures of 0.4 percent of GDP would have to be taken by the authorities if Austria was to reach the 3 percent target in 1997.

Mr. Prader confirmed the staff's estimates, noting that the authorities estimated that the additional required adjustment could be between 0.3 and 0.4 percentage points.

Mr. Newman remarked that Austria, by maintaining a long-standing peg to the deutsche mark, might be the first example of some of the consequences of a monetary union, notable among them, an inability to pursue an independent macroeconomic policy. Concerning the prospects for a rapid European recovery in the latter part of the year, policy choices of the larger members of the union would determine how difficult the adjustment of the smaller members would be.

Ms. Srejber remarked that policy independence was an elusive concept for a small open economy. The ability of a country like Austria to pursue an independent monetary policy would be constrained under any exchange rate regime.

Mr. Esdar pointed out that the need for fiscal adjustment in Austria was not exclusively related to the Maastricht Treaty requirements. Rather, the adjustment measures were desirable in their own right, notably to correct the unsustainable fiscal situation brought about by previous policy slippages.

Mr. Newman, turning to the issue of macroeconomic policies under monetary union, remarked that the macroeconomic policy independence of individual participants in monetary union would be constrained, not merely because they would not have control over monetary policy, but also because of limits on fiscal policy. The inability to finance budget deficits through central bank loans would limit the size of the deficits. Loss of fiscal independence would require many European countries to make adjustments in parts of their government spending. Many of the elements of the countries' social contracts that had been important elements of their success over the past 50 years would be affected. That underscored the need to develop an overarching macroeconomic policy at the union level.

Mr. Prader said that policy dependence was not necessarily a bad thing, provided that a country benefited from the engine of a virtuous economy, which was the case in Austria's relationship with Germany. Austria was committed to meeting the Maastricht criteria. In fact, Austria's tradition and record of fiscal prudence—the country had been using the rule of thumb of 2.5 percent for its deficit to GDP ratio—suggested that Austria's fiscal effort would take place irrespective of the Maastricht requirements.

The staff representative from the European I Department said that the authorities did not focus merely on the deficit—their objective was also to achieve a substantial reduction in the debt to GDP ratio in 1997 relative to that in 1996. That could be achieved through privatization or by sales of financial claims held by various decentralized government bodies. In addition, the European Union might permit reclassification of certain government bodies. In that way, the debt owed by those entities could be excluded from the calculation of general government debt.

The staff had analyzed the expected effects of EU membership on the Austrian economy in the background paper for the 1994 Article IV consultation, the staff representative continued. There was as yet insufficient information to report on the estimated actual effects. However, the staff was planning on studying the economic impact of EU membership and intended to report the findings to the Board one year hence. Unofficial data suggested that Austria's exports to EU and imports from EU had grown at annual rates of 11 percent and 8 percent, respectively, since becoming a member at the start of 1995. In line with expectations, agricultural employment had decreased and bankruptcies had increased in 1995. Finally, competitive pressures, by leading to declines of prices, had positively affected household real incomes.

Privatization was desirable primarily on economic efficiency grounds, the staff representative continued. However, as the proceeds from sales of public assets were intended to be used to reduce the outstanding government debt, the realized price would also be important. At the moment, stock market valuations were favorable to the government's plan.

Mr. Daïri expressed concern that the Fund sometimes put excessive emphasis on the need to sell off public assets without due concern for the market situation. That meant that the countries sometimes could not obtain the best price for their assets.

Mr. Esdar remarked that he was more concerned that the desire to find perfect timing for the sale of their assets allowed member countries to delay structural adjustment or postpone privatization indefinitely.

The staff representative from the European I Department said that, while the staff would like to see Austria aim for a small current account surplus, it did not advocate that the current account become a macroeconomic target. Selecting the fiscal objectives as the focus of government policy was appropriate and, provided those targets were achieved, the current account balance should improve in tandem. The staff also recognized that, in the short run, the current account should be allowed to move into deficit, acting as a temporary shock absorber.

Mr. Cathcart made the following statement:

In the area of fiscal policy, the authorities should be commended for putting in place measures in 1996 and 1997 to reduce the fiscal deficit. But the measures have come belatedly, with a valuable year lost. With a structural deficit of over 6 percent in 1995 and a spiraling debt/GDP ratio, these measures were badly needed. The staff is right to welcome the cut in the deficit which looks like a significant development.

The impression given in the report is that the authorities are in danger of missing the Maastricht wood for the trees. Thus, achieving the fiscal consolidation is a priority because it will facilitate first round EMU membership, rather than in its own right. The emphasis is on the "crash program" of contingency measures, while privatization is justified by the authorities purely on its debt-reducing properties.

The messages, as for other aspirants to membership of monetary union, should be as follows: a medium-term framework for fiscal policy is desirable; the aim should be to get the deficit well below 3 percent; permanent measures are better than one-off measures; slippages should be avoided; expenditure cuts are likely to be superior in terms of saving and growth to tax rises; and, above all, that fiscal consolidation should be sustainable.

Further measures will be need if the deficit is to be brought below 3 percent on a lasting basis. The 1 percent medium term deficit target mentioned in the report sounds about right: the government should actively plan to realize this target. There is a point in the body of the staff report about the need for supporting action by regional government which could have been brought out in the staff appraisal. As for specific further fiscal measures, the focus on subsidies and on the civil service wage bill, and on pensions could all prove fruitful areas for cuts.

"It is not surprising that major structural reforms are not part of the present package" says the staff appraisal: this looks like a coded message. While fiscal consolidation may have been judged—rightly—to take higher priority, there are nevertheless pressing concerns in the structural side. The staff appraisal could have made this point more forcefully.

The labor market discussion contains a thoughtful analysis of competitiveness. The report says that aggregate real wage flexibility is relatively high; and, certainly, unemployment is low relative to the rest of the EU, suggesting fewer rigidities. But this good behavior needs to be built on. The staff argues that there is real wage flexibility in the manufacturing sector, which helps Austria maintain export competitiveness. However, that there is little relative wage flexibility. With productivity increases in the manufacturing sector exceeding those in other sectors, whole-economy unit labor costs have risen, and so we can expect the price of services—including traded services—to have risen relative to manufactures. The key policy advice is to promote greater wage differentiation; the lack of differentiation has probably been one of the factors behind the recent pick up in unemployment. Mr. Newman refers to the fact that Austria's hands will be tied in monetary union. The point to emphasize is the need to improve the flexibility of the labor markets and allow for internal adjustment. That is the message that needs to be sent, not just for Austria, but also for other aspirants to monetary union membership.

Privatization has recently made slow progress and an acceleration would be in order. The gains from privatization come from increased economic efficiency, not one-off budgetary gains.

The statistical data shortcomings are noted in the report. The staff seems to think that they are temporary. A *Financial Times* article on April 30 touched on the issue. The General Secretary of the Chamber of Commerce is quoted as saying the statistical office has "to set priorities and stop counting things like apple trees and pigs." I am in no position to judge how well placed this criticism is, but the staff notes that there is a need to bring provision of statistics back into line with best practice, and I support that recommendation.

Mr. Al-Tuwaijri made the following statement:

Recent developments in Austria have been encouraging. The authorities have agreed on a timely and ambitious consolidation package to reverse the deterioration in the fiscal accounts. This package enjoys widespread support and has clearly commanded confidence in the markets. This being said, a number of downside risks remain, and, as other have emphasized, further efforts may be required to ensure that Austria is able to meet the Maastricht criteria next year.

Given the dynamics of the debt and fiscal deficit, there is a case to be made for a more ambitious consolidation effort. However, the current weakness in economic activity complicates such an attempt. At the same time, recent data on economic activity in Germany could heighten downside risks, especially to revenue performance. This underscores the need for the authorities to carefully monitor developments with a view to ensuring strict adherence to the budget. In this connection I welcome Mr. Prader's indication that the authorities intend to review the budget in the fall and are prepared to take additional measures if needed at that time.

For the medium term, I would share the view that a more ambitious fiscal and structural reform program needs to be put in place. Here, the fiscal consolidation effort needs to focus on expenditure restraint. Austria's revenue to GDP ratio is quite high, and I would encourage the authorities to seize every opportunity possible to bring this ratio down. Such strategy can only enhance the economy's long-term competitiveness. In this connection, I am encouraged to note that the current budget includes a number of reforms that are expected to have a lasting effect on expenditures.

Adherence to a credible and ambitious fiscal stance reinforces the stability that Austria has gained from its peg to the deutsche mark. The disappearance of interest rate differentials with Germany is a clear signal of markets' confidence in Austria's policies and efforts to meet the Maastricht criteria.

With these remarks, I wish the authorities further success.

Mr. Kaufmann made the following statement:

Despite slower than expected GDP growth in 1995, Austria's performance still compares favorably with that of other Western European countries. Inflation is low and on a downward trend, unemployment figures are below 4 percent and private savings rates are high.

However, despite the overall good performance, the outlook for Austria is somewhat more cloudy than it used to be, a development also known in one of its neighboring countries, namely Switzerland. If comparing the two economies, we can see that currently they are sharing some major achievements and problems. While both countries have been able to conduct a successful monetary and trade policy, and founded a great deal of their economic success on a policy based on social consensus, both of them have recently been suffering from rapidly deteriorating public finances and structural weaknesses in the domestic sector, a development that endangers the competitiveness of the external sector.

Let me only touch one of the successful areas, namely monetary policy, and then focus attention on public finances and structural weaknesses.

In the monetary sector, the Austrian Central Bank's continuation of its long established policy of using the deutsche mark as a nominal anchor has led to impressive results. The maintenance of an exchange rate peg has guaranteed monetary stability and low interest rates. The central bank has acquired a high degree of credibility which will be of special importance in view of the fiscal tightening ahead and the drive to improve the international competitiveness of Austrian goods and services.

Let me turn to public finances, which are clearly the Achilles heel of Austria's economy, and represent the major challenge for the authorities in the short and medium term.

With the public deficit increasing by 4 percentage points in only 4 years, up to currently 6 percent of GDP, the country is now trailing most other EU partners. Consequently, the public debt figure has risen to about 70 percent of GDP, well above the Maastricht target. Even more worrisome is the fact that much of the deficit is of structural nature, due to increased expenditures for social security and public sector wages, tax releases in 1994, and contributions to the European Union.

Both the political willingness to enter the European Monetary Union at the earliest possible stage and economic reasons imply that reforms in the fiscal area must rapidly be implemented. On this point, I fully agree with Mr. Esdar. I therefore welcome the comprehensive fiscal consolidation program proposed by the authorities for 1996 and 1997, described in the excellent statement of Mr. Prader. I especially commend the Austrian government for reaching an agreement that builds on a broad-based consensus including the lower levels of government, which also have to make substantial fiscal consolidation efforts. The social consensus achieved strongly increases chances that the proposed package will be successfully implemented.

Since the measures envisaged largely emphasize expenditure restraint, they provide an incentive for a more efficient use of public resources while also reducing competitive distortions in the economy. This leads me to the structural weaknesses of the Austrian economy. Although I understand the authorities' priority in achieving rapid fiscal consolidation in view of the EMU deadline, tackling the structural problems should not be put on the back burner for too long. In order to strengthen competitiveness, attention needs to be drawn to legal and institutional impediments. The restructuring and privatization of state enterprises is bound to provide significant efficiency gains to the economy. Also, existing labor market regulations, such as obstacles to part-time work or inflexible working hours, should be improved.

With these remarks, I wish the authorities all the best in their endeavor.

Mr. Kang made the following statement:

I concur with the thrust of the staff's appraisal, and Mr. Prader's succinct statement is quite useful as a guide to understanding the authorities' efforts for early and decisive action. I share the Austrian authorities' optimism and the vigorous spirit of reform. As previous speakers have mentioned, even though Austria has maneuvered its monetary, foreign exchange, and external trade policies well and her economic stability has been maintained successfully, the papers illustrate the common problems of many EU countries. In particular, in spite of recent efforts, its public finance development has deteriorated in recent years compared with some improvement in neighboring countries.

I share with other speakers the concerns relating to the generous pension system along with an already high dependency ratio, the rather rigid labor market, and the wage decision process and high government involvement in the banking, housing, and industry areas.

Austria is an affluent industrial country with an enviable cultural asset. However, I am perplexed by some aspects of this mature country and raise the following examples:

First, as the staff mentioned, the social partnership system has contributed to stabilizing the economy through cooperation among government, employers, and the laborers, but I wonder how that level of partnership could be maintained in the normal economic environment and in the highly competitive global market.

The Swedish chair regards the pension system as representative of the structural inefficiencies, but to my mind, this social partnership provides the basis for the present over-generous pension system. In this area of fast changing industrial and technological environment, it is not easy for me to understand the existence of the system. The staff may wish to comment on the prospect and the viability of the system in the future.

Second, in Table IV-1 on page 31 of the background paper, even though different levels of governments are involved in revenue collection, the share by the states and the municipalities in 1995 is only 7 percent of the federal government collection. In the more general context, I wonder whether fiscal federalism is always a good case. Recently, I had the opportunity to visit the Marshall Islands and the Federated States of Micronesia. Both countries have a population less than 100,000. They have similar political and administrative layers which resemble those of the United States, and the three-tier jurisdiction system at both the state and the federal levels.

Third, while seeing good performance in stabilization policy due in part to the nominal anchor, some smaller economies might be attracted to adopting a peg system. Austria has quite advanced industries, and its tourism had contributed to the good shape of the current account. As Austria envisages joining EMU, any argument on this exchange rate peg is no longer useful. Unless the pegging country maintains the comparable competitiveness of the other peg country, it would self-limit the room to adjust the imbalance. This argument may be valid for the larger peg system of EMU.

Austria used to be at the eastern end of Europe, but now it is in the center. By this, I mean that it brings opportunity but also entails risk. I am sure Austria will succeed in overcoming today's difficulty with a vigorous spirit of reform.

Mr. Mori made the following statement:

Austria achieved a privileged economic affluence and welfare despite a series of structural rigidities, such as those mentioned in Ms. Srejber and Mr. Palmason's well-written and interesting statement. From the Austrian experience, one could infer that such rigidities, although costly, have not represented an impediment for Austria to enjoy a healthy growth with low inflation and unemployment, provided that appropriate economic circumstances prevail, such as high rates of domestic savings and investment, ample availability of human capital, and favorable external environment.

It is also interesting to note the fact that, in Austria, the recent widening of the fiscal deficit and, somewhat, the deterioration in the external current account, seem not to cause major changes in financial market behavior. There has been a small interest rates differential with Germany, as well as no major turbulence in the foreign exchange market, allowing Austria to continue the link with the deutsche mark. Past policies of Austrian authorities may explain the market confidence.

However, Austria faces a series of challenges for her economy in the context of her EU membership. First, on public finances, to correct fiscal imbalances for macroeconomic reasons, as well as complying with the criteria for participation in stage 3 of EMU; and to reduce the structural deficit to a sustainable level over the medium run. And, second, structural reforms to shape the economy to an environment of increasing external competition. On these issues I share the concerns expressed by other directors.

The fiscal consolidation program approved by the Austrian parliament seems to address properly the problem of the rapidly deteriorating fiscal situation of recent years, as well as the objective of meeting the Maastricht criterion in 1997. However, there remain some uncertainties to achieve the desired fiscal results, to the extent that the economic performance of Austria's main trading partners seems still sluggish. In addition, fiscal restraining measures may have adverse impact on the activities that, in turn, could result in lower government revenue. Therefore, contingency measures might be considered in the event of slippages.

The question of structural fiscal imbalances, mainly represented by growing deficits of the social security funds, should also be addressed in a timely fashion in view of the aging population.

The competitiveness of the Austrian economy has been and will be challenged considering Austria's membership in the EU and increasing trade relations with Eastern Europe. In this context, steps in structural reforms, specially in the labor market, become essential to eliminate market rigidities in order to allow prices to reflect properly the factor productivity of each sector, especially in the nontraded and tourism sectors. Privatization and measures to facilitate economic activity should also be contemplated.

Next, I will make a brief comment on the staff's observation that, I quote, "as an affluent industrial country, Austria might even wish to aim for a small current account surplus." Although there seems to be no major problem of Austria having a current account deficit, the staff is correct, and it is desirable in terms of global welfare that Austria, and other industrial countries, could generate surpluses to allow transfers of net resources to developing countries. Finally, we commend the Austrian authorities for their continued and increasing ODA contributions.

Mr. Verjbitski made the following statement:

The staff papers provide a thorough, high-quality analysis of both the present state of Austria's economy and its medium-term prospects. On balance, by European standards, Austria has been quite successful in attaining over the years high rates of investment, saving, growth and employment in a favorable environment of low interest rates and subdued inflation. As I find myself in broad agreement with the staff appraisal, I shall focus my brief remarks on key policy issues.

First, on the monetary side, the long-time peg of Austria's currency to the deutsche mark has served the country very well by enhancing the credibility of the authorities' policies within Austria's unique framework of social partnership and harmonious industrial relations. For this exchange rate peg to be sustainable, the authorities will need to ensure a high degree of convergence of the macroeconomic fundamentals with Germany, which accounts for the bulk of Austria's trade in goods and services.

Second, the deterioration of the fiscal imbalances in Austria in the last three years is a matter of serious concern, given the recent trend toward fiscal consolidation in other European countries. So far, the high costs of Austria's accession to the EU have only exacerbated the problem. In this regard, the authorities' determination, confirmed in Mr. Prader's helpful statement, to undertake an extraordinary effort over the next two years and achieve budgetary savings of almost 5 percent of GDP, is encouraging. Like Mr. Wijnholds and other previous speakers, I believe that this effort will need to be continued in the period beyond end-1997, perhaps, with somewhat greater reliance on sustainable structural reform measures in the public sector, and in the social security and pension system. Excessive reliance on proceeds from privatization of public enterprises to finance general government fiscal deficits is not sustainable in the long term, and it could only postpone the tough policy choices to a later time, which may render them even more difficult to implement in the circumstances of Austria's aging population.

Third, I note from the excellent background and selected issues papers that the Austrian Institute of Economic Research (WIFO) estimates Austria's potential output growth rate in 1995 at about 1.25 percent of GDP, which means that there was probably no output gap last year. Nevertheless, the staff chose to assume in its medium-term projections under the two scenarios, output gaps of slightly below 0.5 percent of GDP for both 1994 and 1995. Does this mean that if WIFO's own estimates of the output gap were adopted as the basis for staff projections, the fiscal implications of the baseline scenario would be even more worrisome and require a stronger policy response from the authorities? I would appreciate the staff's comments on this issue.

Fourth, while Austria's international competitiveness remains relatively strong in the manufacturing sector, it has markedly weakened both in the agricultural sector and in services. Austria's entry into the European Union and harmonization of tax and customs' codes with the rest of the EU will inevitably add to the existing competitive pressures on the latter sectors. I fully agree with the staff that for a country with such a high share of tourism in its GDP, as in Austria, nominal exchange rate appreciation represents a formidable challenge at a time of deceleration of inflationary pressures elsewhere in the neighboring countries. Under these circumstances, in the period ahead the authorities would be well advised to aim at separating wage setting in the non-manufacturing sectors from that of the more robust and productive manufacturing sector. Like Mr.Kaufmann, I believe that structural reform should be placed high on the authorities' policy agenda.

Fifth, I would like to request some clarification of one point made by Mr. Flickenschild earlier today to the effect that prices on the Austrian stock market now are fairly high. It may appear from Table A16 on page 77 of the background and selected issues papers that the stock market index in Austria went down both in 1994 and in 1995. Has the index moved much higher since then?

In conclusion, I would like to commend the Austrian authorities for their continued financial, humanitarian and technical assistance to economies in transition and developing countries, and wish them every success in their endeavors.

Mr. Fernández made the following statement:

The economic performance of Austria continues to be outstanding compared to other European Union members. Austria keeps an excellent record on exchange rate stability, low inflation an interest rates, balance of payment sustainability and very low rate of unemployment. Doubts about fiscal consolidation have disappeared. Today we have in place what the staff calls, not without some excitement, "the unprecedented twin federal budgets for 1996 and 1997." The political situation has been clarified after the last general elections and now the coalition government looks pretty strong. This kind of political good news for the European Monetary Union have also come from Mediterranean countries such as Italy and Spain where the political situation has also strengthened significantly.

There is little doubt that Austria will be part of EMU from the beginning. This will be essentially a political event for Austria since, as pointed out by the staff, Austria is already in a de facto monetary union with Germany, meaning that most adjustments in the working of the economy required to become a successful participant in EMU have already taken place.

The wage policy, in particular, is in my view appropriately designed to deal with shocks in a social partnership approach. This chair is among the few that supported the consensus wage setting procedures in Belgium as being a key element in explaining Belgium's low interest rates and exchange rate stability in spite of large fiscal deficits and stock of debt. As in the case of Belgium, the staff is arguing in favor of a more decentralized wage setting procedure in the Austrian economy. This strategy, being perhaps optimal from the theoretical point of view, implies high risks of social conflicts. On wage policies in Austria and Belgium I would adhere to the English saying "if it is not broken do not fix it." Social patterns seem to understand very well the implications of the exchange rate fixing with the German mark and we should expect them to behave consistently with the exchange rate rule in the future.

An interesting issue related to the present Austrian experience is the apparent lack of response from financial markets in the recent episode of fiscal deficit widening. It is true that the relative fiscal situation vis-à-vis other hard currency countries is the relevant variable to be taken into account. However, the huge deterioration in the Austrian fiscal balance, specially marked in 1993 and 1995, coincides, precisely, with sharp reductions in long term interest rates, on the one hand, and with a very small increase in the interest rates differentials with Germany, on the other.

An explanation to this paradox may reside, not only in the consensual wage policy, but also on the fact that financial markets have the strong expectation that the Austrian government will take corrective fiscal measures sooner or later. Of course, until the authorities redress the fiscal situation the economy is in a weaker and more vulnerable position than otherwise.

However, one lesson we could extract from the Austrian example is that the fixing of exchange rates do not guarantee domestic fiscal discipline. On the contrary, cheaper and easier financing, and the apparent no-quick reaction of the financial markets may lead the authorities to underestimate the medium and long-term damages to the economy of large fiscal deficits. This could be one additional argument to support the idea of the need of an agreed rule on maximum national fiscal deficits over the cycle as proposed by Germany within the EMU project. In this regard, EMU may be also of economic interest for a country like Austria if it implies more pressure on the authorities for more timely fiscal and structural adjustments. Mr. Newman, however, has a legitimate point when he argues that a country within the EMU would not have enough instruments to deal with shocks. A sort of economic government of the EMU will sooner or later be established to make the project viable and sustainable. I understand, nevertheless, that it is premature to be specific about this now.

It seems that, taking into account the information provided by the staff, little progress has been made in further deregulation and structural reform in the Austrian economy. In particular, on the issue of privatization I agree with the comments made by Ms. Srejber and Mr. Palmason in their Grey statement. I also share Mr. Daïri's astonishment in this respect. All in all, it seems that a fresh look is needed on the privatization issue in Austria, both to make the economy more efficient and to lower the excessive stock level of debt. I note that Mr. Prader said nothing on this matter in his statement.

Finally, I would like to make some very brief comments on two points. First on the current account. I share with Mr. Esdar the view that nothing should be done regarding the small deficit of the current account, since it is nothing to be worried about. We have been told by Mr. Prader that there is a strong correlation between the fiscal situation and the current account; so, the current account balance will improve when the fiscal position ameliorates. Second, I do not think that the exchange rate element should be overemphasized when discussing the situation of the tourist sector. Structural reforms and greater competitiveness is needed in this sector. The exchange rate debate only distracts the parties concerned from the right policies to be implemented.

Mr. Prader said it would be misleading to conclude that Austria had made little progress in privatization. Austria had had one of the largest nationalized industry sectors, but after the mid-1980s, almost all the nationalized industries had been privatized. Only a few banks remained to be privatized, along with public enterprises at the local and regional levels.

The financial markets had maintained confidence in Austria's ability to correct its fiscal situation, Mr. Prader continued. The interest rate differentials had widened somewhat at the time of the emergence of the budget problems, but not significantly.

Mr. O'Loghlin made the following statement:

I have a few brief points to make, only.

First, it seems to me that the real source of deterioration in Austria's budgetary position in recent years was the very rapid growth in pubic authorities' current spending through 1990–1993—it seems to have expanded about 5 percent per annum faster than GDP over those three years.

Second, there seems a lesson in the Austrian experience—that it takes much longer to recover a position once lost, than it does to deteriorate. After three years of relative looseness on the spending side there was tightness in 1994 and also, in the domestic economy, in 1995—bearing in mind that last year's deterioration was mainly a function of EU membership, where Austria is a net contributor. The current package involves retrenchment through 1996 and 1997—and probably for some years beyond, as further underlying measures are adopted to substitute the temporary elements of the current package.

Third—if I interpret the figures correctly—there is the worrying fact that, but for the current adjustment package, public authorities' current spending was set to rise by a further two points of GDP over 1996–97—a volume increase close to 2 percent per year. The implication is that, with no change in policy, underlying forces are pushing the volume of spending up fully as fast as the economy's potential growth rate.

Fourth, I wonder if perceptions of a country's economic performance may sometimes be over-influenced by its unemployment experience. My impression is that Austria, in terms of economic growth, may not have quite matched the average among its industrial-country OECD compatriots over the last, say, 25 years; but that it may seem to have done better because this was linked with low unemployment.

Finally, linking the last two points, I do wonder whether unemployment may have been kept low through adoption of social programs which may now be the key underlying forces pushing up the volume of spending—and in this way may be sowing the seeds of future economic underperformance.

The staff representative from the European I Department remarked that the staff had not intended to imply that there was no structural content in the fiscal package. Rather, the staff had merely wished to emphasize that the rapid reduction of the fiscal gap had been the authorities' primary objective, while major structural reforms—for example, in the area of pensions—would take more time to design and agree upon, and therefore had not been targeted at the present time. With the disappearing room for independent macroeconomic policies under EMU, Austria's long-standing social partnership might prove to be increasingly valuable as time went on—ensuring high real wage flexibility and allowing adoption of socially and politically difficult measures, while maintaining a high degree of social consensus.

Turning to the question of fiscal federalism, the staff representative indicated that the share of taxes directly collected by the lower levels of government was very low. The Austrian Constitution reserved the initiative to levy taxes to the federal level, and only those not claimed by the federal level were available to the lower levels of government. In the staff's view, it would be preferable to give the regions some more rights in the tax area, so as to establish a better balance between assigned tasks and their own financial resources.

As to the fiscal implications of a lower potential growth combined with a smaller output gap than those underlying the staff's scenario, the staff representative said that the deficit problem would be more acute in those circumstances, because the structural component of the deficit would be relatively larger and economic recovery could generate only limited fiscal improvement through the operation of the automatic stabilizers.

The stock market had reached a low point in October 1995 but it had since recovered, the staff representative indicated. In mid-May of 1996, the all-shares stock market index had stood at 431, a gain of almost 15 percent since last October.

Little progress had been made in the area of deregulation, the staff representative continued. A major study of structural reform aspects had been completed in early 1996 under the auspices of the Ministry of Economic Affairs. The study had made proposals in a number of areas of structural reform, including deregulation. A deregulation commission had recently been appointed and was expected to make its recommendations in November 1996.

Regarding the financial market reaction to Austria's fiscal situation, the staff representative indicated that, although they had risen on several occasions in the course of 1995, the interest rate differentials vis-à-vis Germany had not widened as much as they had at the time of the referendum on EU membership in mid-1994. Another indicator of market tensions during 1995 had been the declines in the international reserves of the central bank. Although they had been subsequently reversed, the declines had been quite substantial in February and March, and particularly so in September and October.

Austria's growth over the past 40 years had been strong relative to other European countries, transforming the country into one with the third highest per capita income among EU member countries, the staff representative concluded. He agreed, however, that unemployment had been kept low by various social measures that now proved too costly to maintain. For that reason, the impressive unemployment record might be difficult to maintain in the future.

Mr. Prader made the following concluding statement:

> I am grateful both for the positive comments and for the constructive criticisms of my colleagues. My authorities are not really in disagreement with the staff on structural issues: it is more a question of whether the glass is seen as half full or half empty. In a country as deeply embedded in the so-called European model as Austria, a single two-year budget that addresses the issue of entitlements possesses considerable symbolic and material importance.
>
> What will really be critical, of course, is the continuation of these reforms. For its part, the Austrian government will submit, this fall, a medium-term program covering the years 1998–2000. It is my understanding that it will rely mostly on expenditure cuts and expenditure restraint. The other side of the equation described by Mr. Newman, namely whether small countries are masters of their fate, includes not only our own responsibility for recognizing constraints and opportunities, but also what happens in the major European countries. And here such developments as the discussion on zero wage rounds and other elements of the German package are quite important. Incidentally, the German problems underline the Austrian achievement of two-year zero wage rounds. In any event, the small European countries have demonstrated that they can deliver significant adjustment results. We will see what the major countries will achieve and whether they will be able to maintain social harmony and avoid paralysis of their economies.

My next issue is the question raised by some Directors about the future of the social partnership. This question is also linked to the issue of wage policy and competitiveness. The eminent American historian Carl Schorske pointed out in a recent interview that the contribution of Austria before World War Two was cultural, not only in terms of such giants as Freud and Wittgenstein, but also in terms of the development of modern economics. The contribution of Austria after World War Two has been the social partnership, which has made an economically successful country out of an endemically poor and politically unstable one. Austria is now the third richest country in the European Union. The establishment of Austria's social partnership received major support, during its initial crucial phase, from the U.S. Marshall Plan, for which we will be forever grateful.

The rather late involvement of the social partners in the formulation of the government's budget package last year may have been one reason why both the size and the implementation of the package were inadequate. I mentioned, this morning, the Austrian advantage of having the second highest real wage flexibility among OECD countries, which places Austria among the best performers in any monetary union. In an Austria without this social partnership, neither the size of our budget program nor this wage flexibility would be imaginable.

Virtual monetary union with the deutsche mark has meant that for better or for worse, Austrian wages have tended to follow developments in Germany. Social partnership is the institutional mechanism through which this flexibility is achieved and enforced.

The deterioration of external competitiveness is a problem that is not unique to Austria, but is shared by other hard currency countries that have been exposed to significant devaluations from their major trading partners. We recognize the specific problems caused by inadequate wage moderation in tourism and the sheltered sectors. At the same time, Austria's competitiveness in the manufacturing sector has been better than Germany's because of higher productivity increases. There has also been a clear widening of sectoral wage differentials. In other words, the record of our dual wage bargaining system is quite good, especially if we also take into account that the issue of excessive wage growth in the public sector has been clearly identified by the government through the virtual zero wage rounds.

Mr. Fernández has argued that devaluations did not play a leading role in the problems of tourism, but were only one of many factors. While I would agree that the exchange rate is only one of tourism's many problems, it is certainly one of the major ones. It is obvious that for the German tourists who make up the core of Austrian tourism, the choice of spending their vacations in northern Italy where people speak German is made much more attractive by a 25 percent devaluation of the Italian lira. I should also mention that besides exchange rate movements, cross-border shopping in the wake of Austria's entry into the European Union played a major role in the worsening of Austria's external account.

Finally, I should say that I appreciate the clear message of support and encouragement for continuing the road of adjustment and reform.

The Acting Chairman made the following summing up:

Executive Directors endorsed the thrust of the staff appraisal. Against the background of the generally excellent economic results in Austria in the past 15 years or so, Directors expressed disappointment over the considerable fiscal slippage since 1992, and warmly welcomed the determination of the new government to reduce the general government deficit below 3 percent of GDP in 1997. Directors were impressed with the broad social consensus for the large fiscal consolidation package equivalent to more than 4 percent of GDP, and with the determination of the authorities to take any additional measures that might be necessary to achieve the objective of ensuring Austria's first-round participation in EMU. Some Directors observed that the size of the fiscal adjustment might well affect economic activity, and that lower-than-anticipated growth in turn could exacerbate the fiscal problem, and thus add to the challenge of fiscal consolidation.

Directors further observed that despite the measures taken, the structural fiscal deficit was likely to widen again after 1997 as some of these measures expired and pressure for tax relief was likely to intensify. Accordingly, they agreed that further structural measures would be needed beyond 1997, preferably on the expenditure side, in order to achieve a sustainable fiscal position, reverse the continuing increase in the debt-to-GDP ratio, and reduce the role of government in the economy. In that context, and noting the looming deterioration in the finances of the pension system, Directors urged the authorities to seize the present window of opportunity for reforms that could put the system back on a sound financial footing. They also urged the authorities to pursue further privatization, both to enhance the economy's efficiency and to alleviate the adverse public debt dynamics.

Directors acknowledged that the hard currency policy had continued to serve Austria well. They observed that the government's fiscal package had been well received in financial markets, and expressed satisfaction with a virtual disappearance of interest rate differentials with Germany. Many speakers welcomed the reduction of official interest rates in line with interest rate cuts elsewhere in Europe.

While the weakening of the external current account in recent years was not seen as an immediate source of concern, its continuation could come to affect adversely the hard currency policy. In that context, Directors observed that the fiscal adjustment now in progress, and the additional measures suggested by them, could contribute to the strengthening of the external current account. Structural problems in the tourism sector also needed to be addressed.

Noting that the growing integration of the Austrian economy with that of neighboring countries had strengthened competitive pressures in goods and factor markets, Directors encouraged the authorities to take further steps at deregulation, particularly in the services sector, and to seek greater labor market flexibility. Directors noted that the unemployment rate, while rising, was still low in comparison to that in other European industrial countries. They stressed the need for wage moderation in order to strengthen competitiveness and to maintain inflation and unemployment low.

Directors commended the authorities for increasing official development assistance above the OECD average, and for their intention to maintain the higher assistance ratio in conditions of budgetary stringency.

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

3. NEW ARRANGEMENTS TO BORROW—REPORT BY DEPUTY MANAGING DIRECTOR

The Deputy Managing Director, Mr. Narvekar, said that Mr. Draghi, Chairman of the Deputies of the Group of Ten (G-10), had informed the Managing Director that, at their meeting in Paris on May 23, the representatives of the G-10 countries and a number of other countries with the financial capacity to support the international monetary system had reached agreement on the main features of new borrowing arrangements to provide supplementary resources to the Fund.

The Deputy Managing Director then proceeded to read the text of the press release on the agreement:

> Mr. Draghi, Director General of the Italian treasury and Chairman of the G-10 Deputies, announced today on behalf of the G-10 countries and a number of other countries with the capacity to support the international monetary system that agreement had been reached, both on the broad principles and on the key substantive points for new arrangements to increase the resources available to the IMF to deal with international financial emergencies. The new arrangements, which will double the resources now available under the General Arrangements to Borrow, will be the first and principal recourse in the event of a need to provide supplementary resources to the IMF. The General Arrangements to Borrow will continue to exist, but the combined amount drawn under the two arrangements will at no time exceed SDR 34 billion.
>
> It was agreed that individual country commitments would be based on relative economic strength as measured by actual IMF quotas as a predominant criterion. Countries will participate on an equal footing with rights and responsibilities commensurate with their commitments.
>
> Mr. Draghi also noted that a number of details will need to be refined in the coming months with the aim of reaching final agreement by the time of the fall annual meetings of the Bretton Woods institutions. He also indicated that the new arrangements would have to be approved by the IMF Executive Board as well as by national authorities.

In conclusion, the Deputy Managing Director indicated that a further meeting of the G-10 had been scheduled for the following month. The Executive Board would need to consider and approve the terms of the new arrangements before they became effective.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/96/49 (5/22/96) and EBM/96/50 (5/24/96).

4. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 95/1 and 95/15 are approved.

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/96/82, Supplement 1 (5/22/96) and EBAM/96/83 (5/21/96) and by an Advisor to Executive Director as set forth in EBAM/96/66, Supplement 1 (5/21/96) is approved.

APPROVAL: April 24, 1997

REINHARD H. MUNZBERG
Secretary