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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 87/76

10:00 a.m., May 20, 1987

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
A. Abdallah	E. T. El Kogali
	Jiang H.
	E. L. Walker, Temporary
	D. C. Templeman, Temporary
J. de Groote	H. G. Schneider
	H. S. Binay, Temporary
	M. Hepp, Temporary
	T. Alhaimus
	S. K. Fayyad, Temporary
G. Grosche	B. Goos
	Hon C.-W., Temporary
	J. Hospedales
	M. Foot
H. Lundstrom	
M. Massé	D. McCormack
	C. V. Santos
	I. A. Al-Assaf
	L. Filardo
	V. Rousset, Temporary
G. A. Posthumus	J. de Beaufort Wijnhods
	I. Sliper, Temporary
G. Salehkhou	O. Kabbaj
	L. E. N. Fernando
	T. Morita, Temporary
	N. Kyriazidis

L. Van Houtven, Secretary and Counsellor
R. Gaster, Assistant

Also Present

A. M. Hyera, Ambassador of Tanzania; R. Mariki, Minister-Counsellor of Tanzania. IBRD: F. Agueh, Eastern and Southern Africa Regional Office. African Department: A. D. Ouattara, Counsellor and Director; R. J. Bhatia, Deputy Director; G. E. Gondwe, Deputy Director; J. Artus, I. A. H. Diogo, M. E. Edo, S. N. Kimaro, J. D. Simpson. European Department: M. Guitián, Deputy Director; J. J. Hauvonen, L. J. Lipschitz, J. T. Reitmaier, H. Ungerer. Exchange and Trade Relations Department: L. A. Whittome, Counsellor and Director; J. T. Boorman, Deputy Director; A. Chopra, P. Fontana, H. Junz, S. Kanesa-Thasan. Fiscal Affairs Department: W. R. Mahler, Jr. Legal Department: A. O. Liuksila, J. M. Ogoola. Advisors to Executive Directors: E. Ayales, A. Bertuch-Samuels, L. P. Ebrill, S. M. Hassan, G. D. Hodgson, P. Péterfalvy, A. Vasudevan, K. Yao. Assistants to Executive Directors: M. Arif, O. S.-M. Bethel, F. Di Mauro, M. A. Hammoudi, L. Hubloue, O. Isleifsson, S. King, M. A. Kyhlberg, M. Lundsager, R. Manfredi Selvaggi, J. A. K. Munthali, J. K. Orleans-Lindsay, W. K. Parmena, G. Schurr, B. Tamami, H. van der Burg, Wang X., D. A. Woodward.

1. TANZANIA - 1987 ARTICLE IV CONSULTATION, AND REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1987 Article IV consultation and review under stand-by arrangement with Tanzania (EBS/87/88, 4/28/87). They also had before them a background paper on recent economic developments in Tanzania (SM/87/103, 5/8/87).

His Excellency, A. M. Hyera, Ambassador of Tanzania in Washington, D.C., and Mr. R. Mariki, Minister-Counsellor, were also present.

Mr. Abdallah made the following statement:

The Tanzanian authorities wish to thank the staff for its frank analysis and appraisal, though they do not fully concur with everything in the staff report. For instance, in some areas, notably exchange rate policy, the authorities' own experience and feel for the economy leads them to conclusions somewhat different from those of the staff. Tanzania has not only succeeded in keeping the program on track but in some important areas it is ahead of the prescribed targets--such as those on interest rates and exchange rates. The authorities intend to maintain this progress for the remainder of the program and over the medium term.

As the staff has explained, "the Tanzanian authorities have generally implemented with timeliness the adjustment measures envisaged under the stand-by arrangement" and all the performance criteria for end-September and December 1986 were observed except for the ceiling on total domestic credit at end-December, for which the authorities are requesting a waiver from the Board. That slippage has resulted from underlying structural problems related to transportation, crop processing, and marketing, the long-term solution of which will be addressed in the context of the structural adjustment program. In the short run, the authorities have taken prompt measures--as explained below--to streamline the processing and marketing system and to contain the marketing board's bank overdrafts. In all other areas of the adjustment program, the authorities have persevered with impressive determination and indeed by the date of this midterm review, the objectives of the 18-month stand-by program were fully within reach. It has also become clear that the program turned out to be an important complement to Tanzania's medium-term Economic Recovery Program (ERP) 1986/87-1988/89 which was presented to a Consultative Group meeting in Paris in June 1986, where it received broad donor support. Starting at the beginning of the ERP, the stand-by program had the effect of accelerating and giving momentum to the entire recovery and adjustment effort. In addition, as the stand-by program was implemented in the framework of the national budget, most of the adjustment measures took the form of prior actions. Indeed, the impact of some of those prior actions--particularly on agricultural production and marketing--was immediate. Such measures included the large initial devaluation, the 30 to 80 percent increase in producer prices, the decontrolling of one third of all the previously controlled prices, improvements in the system by which exporters retained some foreign exchange earnings for their imported inputs, and continuing reforms in the marketing system. Fiscal and monetary measures were also front-loaded, including a 50 percent increase in interest rate levels, so that the impact of the changes commenced fully with the program.

On the whole, the Tanzanian economy has responded well to these measures, with the help of favorable weather conditions. The authorities now expect that in 1986/87 real GDP will increase by 3.5 percent as stipulated in the ERP compared with an annual growth rate of less than 1 percent during the first half of the decade. The improved domestic supply situation underlying appropriate financial policies has contained the rate of inflation to 32 percent in 1986 compared with 33 percent in 1985, notwithstanding the sharp exchange rate depreciation and the pass-through of the resulting costs, domestic price deregulation, and the producer price hikes that occurred during the second half of 1986. The favorable economic results attained so far rest mainly on the good performance of the agricultural sector. The manufacturing sector has continued to be constrained by lack of imported spare parts and intermediate goods and has consequently been operating well below capacity because of delays in the disbursements of commitments made during the Consultative Group meeting.

The Government has been rather concerned with the slow pace of recovery of the manufacturing sector and has given it increasing attention. Available foreign exchange is assigned to priority sectors and in some cases the Government is advancing foreign exchange to some priority lines of manufacturing. Producers have also continued to retain part of their export earnings to buy foreign inputs. However, the own-exchange scheme under which importers are authorized to use their own foreign exchange for imports has taken on an important role, as it is expected to finance more than 20 percent of imports in 1986/87. With the expected arrival in 1987 of disbursements of the foreign exchange pledged during the last Consultative Group meeting, the manufacturing sector's performance should improve substantially.

The Government is updating the investment code to encourage foreign investment in the various sectors. Changes include enhanced possibilities of repatriation of profits and dividends. In the case of the tourist industry, the Government has made considerable progress toward rehabilitation since the inception of the ERP, including the construction or management of several international hotels with the participation of foreign private investors.

The marketing system is undergoing a major restructuring to improve efficiency and to enable it to cope with increased production levels. Since 1985/86, the procurement of crops and some processing and marketing functions were transferred from marketing boards to cooperative unions as the marketing boards were not performing their functions efficiently. In a further move to eliminate marketing board monopolies and to foster competition, the government has allowed private traders to compete with the National Milling Corporation (NMC) in the procurement and distribution of grains. In addition, some large private farms are allowed to export their agricultural produce directly. Most of the marketing boards have responded to these reforms by restructuring their operations and by reducing their labor force substantially. Nevertheless, the bumper harvests of maize and cotton in 1986/87 have exposed major weaknesses in the NMC and the Tanzania Cotton Marketing Board (TCMB), weaknesses that the authorities have undertaken to rectify during 1987/88.

Despite recent restructuring to increase efficiency, the NMC has registered increasing deficits in the form of bank overdrafts. In 1986/87 the problem was exacerbated by the need to finance large maize stocks which stood at 217,000 tons in February. The unusually large stocks were a result of the bumper harvest and the NMC policy of a high uniform nationwide procurement price coupled with a weak distribution network and competition from private traders. In the short run the authorities have taken a number of measures to reduce the stocks and the corresponding bank overdraft. The measures were geared essentially to adjusting the NMC distribution and pricing policies so as to speed up the elimination of the excess stocks. In addition, by midyear when the prospects for the 1987/88 crop become clearer, the Government will decide on the amounts to be exported. The Government has also decided to purchase 80,000 tons of maize to be stockpiled in a strategic grains reserve. Meanwhile, the role of the NMC itself is under review, and the authorities will announce the necessary institutional and functional changes before the end of this year.

So far as cotton is concerned, the TCMB registered substantial losses and borrowed heavily from the banking system. As explained in the staff report, the reasons were mainly related to bottlenecks in processing and transportation but the producer price relative to the prevailing world price in 1986 contributed to the T Sh 1.8 billion estimated total operating loss. In January and February 1987 the processing and shipping of cotton picked up somewhat when ginneries received lubricants and spare parts and railway equipment was specially earmarked for the transportation of cotton. Nevertheless, the Government, with World Bank assistance, has decided to put in place institutional reforms so as to attain financial balance in 1987/88 and surpluses thereafter.

The objective of fiscal policy in 1986/87 was to reduce the overall budgetary deficit by 5 percentage points compared with the previous year, to T Sh 17.0 billion. However, after eight months, the authorities realized that the objective could not be attained because of a T Sh 1.15 billion estimated revenue shortfall caused by insufficient customs duty collections, and a substantial shortfall in sales tax receipts resulting from the closure of key industries following a breakdown of power generators. At the same time, the authorities were anxious to stabilize the check float at the normal level of 9 percent of current expenditure by the end of the fiscal year--a reduction from the end-1985/86 level of T Sh 6.7 billion to T Sh 4.5 billion.

In April the authorities took decisive action by introducing new revenue measures, postponing some expenditures and raising the level of nonbank borrowing to ensure that the program targets remained achievable. The revenue measures are expected to raise T Sh 1.45 billion during the remainder of this year, thus exceeding the estimated revenue shortfall. The measures include increases in sales taxes, improved tax collection, the sale of obsolete government equipment, and the collection of dividends from some public enterprises. The postponed development expenditures are estimated at T Sh 450 million while the level of nonbank financing was raised by T Sh 550 million. In the meantime the Government has put in place an effective expenditure monitoring system to control the check float.

Monetary policy has been managed closely in line with program objectives during the first half of 1986/87 and good progress is being made toward attaining positive real interest rates. To this end nominal interest rates have been increased steadily. On April 1, 1987 interest rates were increased by 2-3 percentage points. As a result, the one-year savings deposit rate is now 21.5 percent, equivalent to 67 percent of the 1986 rate of inflation, while the maximum lending rate on consumer loans is 29 percent, 91 percent of the rate of inflation.

The high rates of interest are beginning to restrain production, especially in the agricultural sector. They contributed importantly to the levels of losses incurred by the cooperatives and by the marketing boards. The authorities expect to lower the nominal rates of interest in 1988 as interest rates turn substantially positive in real terms with subsiding inflation.

Developments in the external sector at the beginning of the program in mid-1986 are satisfactory, and the current account deficit for the whole year is now estimated to have been reduced by 49 percent--to $175 million--while there is now a surplus on the capital account following successive years of net capital outlfows. With regard to the improvement on the current account, the exchange rate policy played an important role in facilitating considerable producer price increases. The role of the exchange rate policy in enhancing the long-run competitiveness of non-traditional exports will also be important, but the authorities maintain that contrary to the staff emphasis, priority should now be shifted to the removal of bottlenecks on the supply side.

With regard to exchange rate policy, therefore, the authorities consider the current rate of exchange rate adjustment--faster than that called for under the stand-by arrangement--to be adequate. They reiterate that the exchange rate was depreciated at the beginning of the program in June from T Sh 17 = US$1 to T Sh 40 = US$1 and through weekly adjustment to T Sh 60.32 = US$1 as of Monday, May 18. The authorities have cited a number of reasons why it is politically and economically imprudent to accelarate the pace of exchange rate depreciation at this time.

(1) The time lags involved between exchange rate depreciation and supply response under Tanzanian circumstances should be taken into account. The substantial depreciation has so far led to a positive supply response in the agricultural sector, but problems such as those relating to cotton demonstrate that processing and transportation require additional time and attention rather than monetary manipulation. Indeed, as indicated in the staff report, the industrial sector is operating at a very low capacity rate due to lack of foreign exchange for imported inputs and spare parts. Thus, while the authorities do not disagree entirely with the staff that exchange rate policy has an important role to play in stimulating the export of manufactured goods and in raising producer incomes, they do not consider the existing regime to be inconsistent with this objective. They simply wish to stress that apart from exchange rate changes, the supply-side bottlenecks also need to be given equal, if not greater, attention. They have also said that the business community, including manufacturers and exporters, had urged the Government to slow down the pace of exchange rate adjustment--expressing the view that at T Sh 50 = US$1, most exports were already profitable.

(2) Politically, the authorities consider that the system will not tolerate accelerated depreciation because they have not been able to associate "policy designs by the Fund

in this area with success stories." Whereas in Tanzania the ERP and the stand-by program have enjoyed a broad-based support so far, any acceleration is bound to generate unnecessary antagonism to the program due to lack of visible progress, especially on the industrial front. The authorities stress that recent experience in the neighboring country of Zambia is bound to have some political repercussions.

(3) The authorities are still fully committed to attaining the equilibrium rate by mid-1988 and they believe that they are making good progress toward that target. They consider that at the present rate of T Sh 60.32 = US$1 against the background of the falling rate of inflation, they are close to the equilibrium rate of exchange. In this connection, they "strongly resent the constant attempts of the Fund staff to legitimize the black market for foreign exchange." They point out that under the sociopolitical circumstances of Tanzania, too little is known about the illicit black market including its motivation, magnitude, and behavior for the country's authorities to use it in estimating the equilibrium exchange rate. They would prefer an approach that involves the elimination of historical overvaluation which might be acceptable and explainable to all parties.

The medium-term prospects remain precarious, but the authorities are confident of attaining viability. In the meantime, the Government has concluded bilateral debt rescheduling agreements in the Paris Club context with the Governments of the United States, the United Kingdom, Germany, France, Switzerland, and Japan, and expects that agreements with the remaining creditors will be completed within a month. Nonetheless, Tanzania's debt service burden will remain heavy up to the end of the decade.

Mr. Santos made the following statement:

I broadly agree with the staff appraisal, and endorse most of the staff's policy recommendations. I support the proposed decisions.

As there was general pessimism concerning Tanzania's initial adjustment efforts, the Tanzanian authorities deserve our commendation for the progress that has been made over the past year in implementing the adjustment program. The authorities took several major actions, in particular the devaluation of the Tanzanian shilling. These actions ensured a strong start for the program, restoring confidence in the authorities' ability and determination to address the urgent need for comprehensive adjustment.

The authorities' substantial adjustment efforts have begun to show positive results, with a generally encouraging economic performance in 1986 and the early part of 1987. Preliminary indications are that all the main objectives of the 1986/87 program will be achieved, including in particular the economic growth target of 3.5 percent--reflecting the significant expansion of agricultural output caused by improved incentives and better weather conditions. As a result, and coupled with the enhanced availability of imported consumer goods, the rate of inflation has not accelerated as one would have expected. The authorities are continuing to follow agricultural policies designed to attain the long-term objectives of self-sufficiency in food production and the maximization of the value of cash crops. These policies are steps in the right direction, as performance in the industrial sector is still below potential because of the shortages of spare parts and essential outputs, despite some signs of recovery. I encourage the authorities to broaden and sustain the emerging economic recovery by prudent implementation of their adjustment policies. This will stimulate activity in the industrial sector, under the medium-term growth-oriented adjustment strategy.

Despite the progress made so far, the Tanzanian economy faces large imbalances, and the staff report also implies that the authorities should accelerate the pace of adjustment with particular reference to the exchange rate and the proposal that an equilibrium rate should be reached in mid-1988. However, considering the political and social risks involved, and given the recent unfortunate experiences of some of Tanzania's neighbors, I strongly support Mr. Abdallah's call for a flexible approach to the speed of adjustment in Tanzania. Since the authorities have already demonstrated a capacity to take additional measures in a timely manner, and have shown persistence in program implementation, the Board should adopt a pragmatic approach. I would therefore encourage staff flexiblility in future policy discussions, which would accommodate unforeseen developments and ensure the timely completion of policy discussions, without the undue delays that can stem from different policy stances.

Mr. Foot noted that the authorities had made significant progress so far under the stand-by arrangement, helped both by the adjustment measures that they had put into place, and by relatively favorable weather conditions. Growth had picked up and inflation had remained under control. The Tanzanian case was an encouraging example of the surprising speed with which the positive benefits of adjustment programs could begin to make themselves felt, even in a poor country facing major structural imbalances. And although the authorities did not associate depreciation policies adopted in connection with Fund programs with success stories, there was much of benefit to Tanzania in the current program.

The authorities had taken an important first step in tackling the major structural imbalances that had been allowed to build up in the economy, Mr. Foot continued, but the outlook for the economy would likely remain difficult, as the staff's medium-term projections indicated. The net benefits of the program, and in particular of the substantial action already taken on the exchange rate, seemed to have been rather larger than some had initially thought: the inflationary consequences had certainly been smaller than some had feared; the exchange rate depreciation and the pricing and marketing reforms had encouraged a substantial increase in agricultural output; and the own-exchange and export retention schemes had also helped by increasing the supply of consumer goods--which in turn had increased general support for the program--although such schemes should not become a long-run part of the system.

The authorities would however need to maintain, and in some areas strengthen, their adjustment efforts, Mr. Foot remarked. Their willingness to do so was commendable, and was illustrated both by the exchange rate depreciation, which had been faster than the minimum envisaged under the program, and by the additional revenue measures that had recently been announced.

The staff and the authorities would of course judge the nature and timing of any further measures, Mr. Foot said, and the central issue would evidently be the exchange rate. The exact level of the "equilibrium exchange rate" was obviously open to argument, but it was unlikely that the authorities were yet close to it, unless they meant to allow the long-run persistence of complex import controls, own-exchange and export retention schemes, balance of payments imbalances, and a massive gap between the official and the parallel exchange rate. He did not wish to see those various restrictions continue into the long term, although he was not arguing for a brutal pace of adjustment. In Tanzania and elsewhere, there was room for some trade-offs at the margin, both as to the target rate and the speed with which it was to be achieved. The important thing was to illuminate the menu of options for the authorities: if they were reluctant to devalue the currency as far or as fast as the staff would wish, they would presumably have to run correspondingly tighter fiscal and monetary policies, and those options would need to be explored in some detail. He had considerable reservations about making haste too slowly, because that would likely reduce both the quantity and the quality of prospective growth in the economy. At the margin that was however a choice for the authorities.

He was encouraged by the further measures recently announced to increase interest rates, Mr. Foot commented, and by the commitment to achieving positive real interest rates by the middle of 1987. However, the authorities intended to set interest rates on the basis of the expected rate of inflation, presumably because that measure was intended to act as a proxy for the private sector's inflationary expectations. If inflation did not follow its expected course, the authorities should be ready to take further steps, which might also be required if the private sector did not share the authorities' views of the inflationary outlook. It was not unusual for there to be some differences between the public and private sectors on that question, whatever the country.

Although he considered helpful the table in the staff report that showed producer prices in Tanzania compared with those in some of the neighboring countries, Mr. Foot said, it would have been even more helpful had it also included world market prices. Repeatedly, calls had been made in the Board for such tables to be routinely included in reports in countries heavily dependent on agriculture and in those where opportunities existed for smuggling. Agricultural policies were difficult to evaluate without such information, which he hoped would become a common feature of staff papers in such cases.

The authorities had made significant progress in the past six months, Mr. Foot concluded, evident not just to those looking at the aggregate figures but also to Tanzanians themselves. Those gains would have to be protected and extended, and the forthcoming second review and the next budget would be crucial.

Mr. Al-Assaf made the following statement:

I welcome the success encountered by the Tanzanian adjustment efforts in this first and difficult phase of the program.

After several years of deterioration in its performance, the Tanzanian economy has shown signs of improvement. Growth has been restored, allowing an increase in per capita income for the first time in several years; fiscal and balance of payments positions were strengthened; and the inflation rate was stabilized despite a major price liberalization and a substantial adjustment in the exchange rate. While better weather conditions helped to reverse the declining trend in economic activity, the authorities' adoption of a comprehensive program of economic recovery has also played an important role. I commend the authorities for the significant progress achieved so far, and for their flexibility in adapting their policies to unforeseen circumstances.

The budget for 1986/87 further strengthened the restrained fiscal stance adopted at the start of the authorities' economic recovery program. I particularly welcome the efforts to improve the tax system, contain current government spending, and introduce more selectivity in the choice of investment projects. I commend the authorities for adapting their fiscal policy to the circumstances: their readiness to strengthen the stance of their policies is most evident in the corrective measures taken last April to generate additional revenues and to improve the check clearing procedures.

I welcome the authorities' flexible approach to exchange rate policy, and am impressed by their action to accelerate the adjustment of the exchange rate even faster than called for under the program. However, like the authorities, I am not convinced of the need for even faster exchange rate adjustment, as maintenance of their gradual approach will bring the exchange rate to a realistic level. Moreover, the recent general improvement in economic policies, together with the expected sharp reduction in the inflation rate, will, if supported by a cautious wage policy, achieve the desired improvement in international competitiveness. In any event, the authorities are still clearly committed to achieving the equilibrium exchange rate by mid-1988.

The medium-term outlook will in general remain difficult, requiring vigorous implementation of policy reforms and strong support from the international community. Tanzania has a considerable potential for growth, and a wide resource base that permits an export-led growth strategy. The most recent performance of these nontraditional exports is therefore very disappointing, and the authorities should accord a high priority to the revitalization of nontraditional exports. Incentives should be further improved, as should the availability of inputs, including particularly imported raw materials and spare parts. More generally, the authorities must put further emphasis on the rehabilitation of their ailing economic infrastructure if the expected improvement in production and exports is to be sustained. The World Bank can play an important role in this area, perhaps within the context of the forthcoming structural adjustment arrangement.

Finally, I warmly congratulate the Tanzanian authorities for the considerable progress that they have achieved under the program. I support the proposed decisions.

Mr. Fernando made the following statement:

This chair commends the Tanzanian authorities for their commitment to the economic reform program underlying the stand-by arrangement. We appreciate the timely actions taken to keep the program generally on track, and their handling of a difficult situation without apparent social tension. We broadly agree with the staff appraisal, and share the staff's expectation that despite the missed target for domestic credit expansion, all the main objectives of the initial program remain achievable. We therefore support the proposed decisions.

Clearly, Tanzania has a long way to go in settling the large imbalances, and in particular, in achieving balance of payments viability and a sustainable level of debt. The payoff for the adjustment effort--a reasonable rate of per capita GDP growth--must therefore be visible and sustained. Given Tanzania's resource endowment, highest priority should be accorded to agriculture and related industries. Good maize and cotton crops in 1986 again indicate the potential if the basic tools are available--in this instance, price incentives and good weather. The challenge of plentiful supplies to distribution and marketing is relatively easy to address, and deserves stronger support than any hard luck story. We urge the authorities to quickly and firmly define the role of the National Milling Corporation--preferably by strictly limiting its role to that of a buffer stock agency. Adjustment programs can be obstructed by vested interests, such as parastatal organizations, that suddenly find themselves removed from dominance, and the longer it takes to settle their future, the more numerous, perhaps even fanciful, the proposals they would put forward for their continued existence. The attitudinal change necessary for reform cannot be forced upon, or even sold to, government officials who were once the market regulators. The immediate penalty for indecisiveness or delay in this area would be the claims of such government entities on domestic credit, which would deprive the productive private sector of credit.

The check float system presents some potential danger to budgetary discipline, reflecting a lack of treasury control over expenditure and therefore over spending ministries. Although this problem has historical roots, the fight against inflation and the effective pursuit of macroeconomic policies requires the resolution of this basic accounting weakness. A policing function should not be placed on the Bank of Tanzania to ensure that fiscal expenditure is within legal limits. Furthermore, paragraph 11 of the Finance Minister's letter to the Managing Director dated April 27, 1987 states that ceilings on net bank credit to government will be reduced by any excess inflows of external assistance over the expected level. Do contingency plans exist if the level of assistance falls below the expected amount--as it did in 1986? These specific matters also influence the progress made in curtailing inflation. Nominal interest rates on savings are now well in excess of 20 percent, which is an important step toward the achievement of positive real rates of return, though we sympathize with the authorities' concern that lending rates should not rise to the point that they stifle private sector enthusiasm. Gearing ratios in many developing countries are high, and finance costs are a high proportion of overall costs; hence the contribution of reduced inflation to the attainment of positive real rates of interest should be important.

Finally, we are encouraged by the authorities' intention to wipe out the overvaluation and reach a realistic exchange rate. There is no disagreement concerning this goal, only different shades of the same opinion as to how far to go and how fast. Obviously, progress that was too slow would result in trying to reach a moving target, but this has not been the case, as adjustment has occurred much faster than targeted in the arrangement. This is also a matter of prestige and an emotional issue, and the good work done so far by the authorities should not be undermined. Mr. Abdallah has explained why the black market rate is not the correct equilibrium level, and his argument makes considerable sense: under price controls, the black market rate contains many elements other than supply or demand factors. We urge the authorities to keep this matter at the forefront of their program with a view to rapid adjustment, which can be greatly helped by complementary budgetary and monetary policies.

Though we note the cooperation of the Tanzanian authorities, we also recognize that the purchases are largely confined to the first two credit tranches. In addition, we welcome the authorities' close collaboration with the World Bank in continuing and implementing the adjustment program.

Mr. Wijnholds made the following statement:

A corner seems finally to have been turned in Tanzania, and after many years of economic deterioration this is certainly welcome. The program has been broadly implemented as planned; and there has been a substantial increase in external aid, while weather conditions have fortunately also taken a turn for the better. All this adds up to a much improved economic climate--but Tanzania's economic problems are deep rooted and its external position remains very fragile. The program can therefore be seen only as a first, rather modest, step toward addressing these problems. The authorities should therefore strengthen their adjustment efforts: the steps taken so far have led to relative success, but to sustain it, stronger policies may well be required--after all, the law of diminishing returns also applies to economic policies.

While the exchange rate has for a long time been the stumbling block in Tanzania's relations with the Fund, I am encouraged that the authorities depreciated the currency by more than the absolute minimum required by the program. Nevertheless, as the staff says, the Tanzanian shilling remains substantially overvalued, and attaining an equilibrium rate by mid-1988 will require action beyond the present pace of adjustment. I was therefore somewhat disappointed to see that the authorities remain unconvinced of the need for a further acceleration of the exchange rate adjustment. Overvaluation makes an allocation system necessary, with the familiar problems of inefficiencies and waste, while exports will remain uncompetitive and smuggling will continue. However, on the basis of the authorities' performance of the past years, I expect that they will successfully implement their commitment to achieving an equilibrium rate by mid-1988.

The slippages in monetary policy were mainly caused by factors beyond the control of the authorities, and the requested waivers in this area seem warranted. Growth of broad money is however now projected at 18 percent--vis-à-vis the original target of some 10 percent--and domestic credit will increase by 27 percent. Even taking into account the special factors responsible for the overshooting, monetary policy may therefore not be sufficiently tight. With a further currency depreciation in the offing, sufficient supporting policies must be in place to prevent any flare-up of inflation; at a minimum, monetary targets could be reduced if agricultural stocks wind down and the need to finance them decreases. In addition, I am encouraged that real interest rates will shortly become positive--albeit vis-à-vis an expected rate of inflation of 22 percent, which may prove to be somewhat optimistic. Tanzania's structural adjustments and fiscal policies have been good, and the improvement in the fiscal position is particularly noteworthy. I wish only to underscore the need to review the operations of the National Milling Company.

There seem to be two structural weaknesses that hinder the success of the program: the administrative constraints that limit disbursements of external aid; and transportation bottlenecks. It is easily said that the country should do its utmost to reduce these rigidities, but the full resolution of such problems can take a long time. They are, nevertheless, a significant part of the authorities' adjustment program, and the authorities should do what they can to remove these serious bottlenecks.

Mr. Massé made the following statement:

Our views on Tanzania have not changed since the stand-by arrangement was approved last August. I support the general thrust of the staff appraisal, and agree that a number of important and substantial adjustment measures have been implemented during the past year. As we emphasized last August, however, this program is only the first step in Tanzania's adjustment efforts. Strong and sustained measures, such as those contained in this program, will be needed for a number of years if the authorities are to reach their goals of stable growth, low inflation, and a sustainable balance of payments position.

As the staff report shows, the fiscal position has already been strengthened, and the expansion of domestic credit restrained. The package of measures designed to increase control over recurrent government expenditures is one added sign of a firm commitment to a more balanced fiscal policy. Further steps are also required to reduce subsidies to parastatals, make these public enterprises more efficient, and expand the role of the private sector where feasible. The World Bank should continue to play a central role in helping to design reforms in these areas.

Further measures which encourage and expand the economy's supply capacity are also needed. The rate of adjustment of interest rates and the exchange rate were two areas where we did not feel the program was sufficiently ambitious, and we therefore welcome the news that the authorities have met and even surpassed their timetable for adjustments in these important areas. The increase proposed for July 1 will allow interest rates to become positive in real terms, provided that the inflation target of 22 percent for the next 12 months is met. Thus, to avoid any further increase in interest rates, the authorities should meet their inflation target by rigorous control of credit to the public sector and other sectors of the economy, and by meeting the fiscal targets.

The exchange rate issue is more delicate. Several factors suggest that more rapid devaluation and unification of the exchange market is required--the continuing high demand for import licenses; continuing evidence of export smuggling; and the need for more efficient allocation of foreign exchange, so that the manufacturing sector in particular can gain access to spare parts and intermediate inputs. From a purely technical perspective, a more rapid devaluation may be warranted and faster devaluation would also permit further necessary increases in producer prices.

However, we are also aware of the political and social reality in which Tanzanian decision makers have to function. These circumstances obstruct the achievement of an equilibrium exchange rate much more quickly than presently envisaged, and we should therefore be sensitive to the authorities' concerns. The authorities should stay at least 17 percent ahead of the exchange rate to which they committed themselves in the letter of intent, but they should also use any available room for maneuver to reach an equilibrium exchange rate as quickly as possible. The important point is that while a slower movement on the exchange rate may be justified for political and social reasons, it nonetheless implies that fiscal or monetary measures will have to be tougher. The authorities will of course have to judge the costs and benefits of the alternative policies for themselves.

Mr. Hon stated that he agreed with the staff assessment of Tanzania's economy and could support the proposed decisions. He welcomed the generally timely implementation of the adjustment measures required under the stand-by arrangement. All indicative targets and performance criteria for end-September and end-December 1986 had been met, except the criterion concerning total domestic credit. The excess credit expansion was, however, solely due to an unexpectedly large financing requirement for the cooperatives arising from a large crop of cotton and maize. Increased borrowings from the banking system by the Government and the seven marketing boards were well below the ceilings imposed by the adjustment program.

Significant progress had been made in correcting the misalignment of the exchange rate, Mr. Hon observed. A great effort had been made by, the authorities to lower the exchange rate of the shilling by an average of 3 percent a month, instead of the 1 percent a month called for under the program. He trusted that the authorities would continue with a cautious and orderly depreciation of the currency, so as to control inflation and maintain social stability.

Mr. Goos made the following statement:

> The program has been implemented rather successfully so far, and the progress to date substantially mitigates our original concerns about the appropriateness of the adjustment effort. This experience underlines the authorities' commitment to adjustment, as do the policies agreed for the period ahead. Demand management, as well as production, marketing, and pricing policies are consistent with the main objectives of the stand-by arrangement--especially the critical need for further liberalization of the domestic economy. It also appears, however, that liberalization could be facilitated if those efforts were implemented in the framework of a more comprehensive medium- to long-term approach, and I hope that the authorities soon reach agreement on a policy framework paper and a structural adjustment arrangement.
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> Both the authorities and the staff have powerful arguments for their respective positions on the exchange rate question. Without discussing the merits of those arguments, it is important to note that the authorities seem fully aware of the adverse effects of an overvalued exchange rate--a point underlined by the recent large devaluations and the substantial overperformance on the original exchange rate target. The authorities also remain "fully committed to attaining the equilibrium rate by mid-1988," as emphasized in Mr. Abdallah's statement. I am therefore confident that they will continue to use the available scope for further exchange rate action in order to meet the agreed target. Both actual exchange rate performance and financial policies should be closely monitored, to ensure that major shortfalls in the improvement of external competitiveness will be promptly offset by an appropriate tightening of financial policy. The scope for substituting demand-management policies for exchange rate action however might be rather limited, unless the authorities are prepared to compromise their economic growth target.
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> More generally, the disagreement between the authorities and the staff on the appropriate pace of devaluation seems to raise an issue of program design. As our recent discussion on Fund

conditionality revealed, it is in general quite difficult and often politically unacceptable to tighten policy undertakings in the middle of an ongoing program. Thus, rather than agreeing on a specific percentage figure for the desirable devaluation of the exchange rate within a specific program period, it appears more advisable to relate exchange rate undertakings to the development of economic indicators that reflect external competitiveness.

I conclude by endorsing the proposed decisions, including approval of the requested waiver.

Mr. Fayyad made the following statement:

The performance of the Tanzanian economy has improved considerably since the introduction in 1986 of the economic recovery program supported by the present stand-by arrangement. Improvement has been most pronounced in the agricultural sector, which contributes about 40 percent of Tanzania's GDP. While favorable weather conditions were a major factor behind that improvement, the agricultural recovery was also undoubtedly aided by the adoption of a wide range of policy measures. These included sharp increases in the minimum prices of various crops, especially export crops; enhancing the role of private traders and cooperatives in domestic trade and in the importation and distribution of agricultural inputs; and dismantling restrictions on regional grain trade. Prospects for the agricultural sector are likely to improve further with the realization of the authorities' intention to allow cooperatives to export directly, or through agents outside the marketing boards.

It was encouraging to learn that after several years of protracted stagnation, there have been signs of a pickup in industrial activity in early 1987, due mainly to the improved availability of imports and spare parts, following the disbursement of external financial assistance intended to support imports. The authorities' efforts, aimed at rehabilitating and maintaining the existing infrastructure and at reducing the administrative delays experienced in the utilization of external assistance, should help the recovery of the industrial sector.

Demand management has also been strengthened under the 1986/87 program, leading to an effective reduction in the underlying budget deficit, an improvement in credit allocation, and considerable progress toward attaining positive real interest rates. However, in order to guard against an erosion of the gains already achieved, and to improve Tanzania's balance of payments position, a further strengthening of demand management must be achieved. In this regard, I welcome the introduction earlier this year of measures aimed at enhancing revenue and improving tax administration, with a view to reducing the large float of government checks and curtailing credit to the Central Government and marketing boards.

The substantial depreciation of Tanzania's exchange rate under the program has undoubtedly gone a considerable way toward establishing an appropriate structure of relative prices and alleviating pressure on the country's external position. However, as the pace of adjustment in this area has been faster than programmed and a further lagged positive supply response to the depreciation that has already taken place is expected, I share the authorities' view that a further acceleration in the pace of exchange rate adjustment is, at this time, imprudent.

Medium-term external viability depends critically on Tanzania's ability to marshal adequate concessional financing and to secure debt relief through 1991. This makes it all the more important that the momentum of the adjustment efforts, which have led thus far to a successful implementation of the economic recovery program, be maintained and strengthened over a number of years.

Finally, Tanzania has complied with all but one of the end-September and end-December 1986 performance criteria. Given that the noncompliance was largely beyond the authorities' control, and the staff's view that the basic objectives of the 1986/87 program remain achievable, I endorse the authorities' request for a waiver under the current stand-by arrangement.

Mrs. Walker made the following statement:

Tanzania has performed quite well thus far under the stand-by arrangement program, and we commend the authorities for their efforts to adopt the difficult adjustment measures required. The steps that the authorities have taken thus far signal a firm and welcome commitment to this adjustment program. The difficult initial financial and economic position demanded a tremendous adjustment effort, and the most important issue therefore is to continue this effort in a way that will bring about the desired economic growth and financial stability. It is most heartening to note that the main objectives of the initial program remain achievable. Yet, even with a continued adjustment effort along existing lines, the medium-term economic outlook is not without problems, and potential financing gaps could remain large in the next few years. Therefore, adjustment policies must be maintained and strengthened where possible, particularly in the context of a structural adjustment arrangement. The authorities have shown their ability to strengthen measures where needed, and we feel confident that they will continue to do so when necessary.

I will comment on areas where continued efforts are necessary. First, we welcome the authorities' intention to further improve the marketing system, starting with the next crop season. In addition, private importers and cooperative unions should be allowed equal access to foreign exchange, in order to obtain the inputs needed for agricultural production. Second, past practices contributed to the difficulties encountered in dealing with the large crops produced last year, and the marketing boards' procedures and policies need to be revised to accommodate changing conditions. We welcome the review of the National Milling Corporation's operations and responsibilities in grain marketing, and look forward to some indication of improvements to be made in the near future. Similarly, we will look for a turnaround in the financial position of the Cotton Marketing Board during the next crop year.

I found the table comparing official and parallel rate producer prices in Tanzania, Kenya, and Malawi quite informative, and the divergence between the official and parallel rates in Tanzania is clearly larger than that in these other countries. Tanzania's official producer prices might therefore perhaps need future increases.

Unfortunately, the manufacturing sector did not see improvements similar to those of the agricultural sector during 1986, but some constraints on growth in the manufacturing sector will be removed during the next year: quantitative restrictions designed to protect domestic industry will be replaced by a rationalized external tariff regime; and the availability of needed foreign exchange will be an important determinant of the recovery of the manufacturing sector, as there is considerable potential for the revitalization of manufactured exports. Thus, we urge the implementation of an efficient allocation system for foreign exchange.

The failure to control recurrent government expenditure in late 1986 was disappointing, as was the revenue shortfall in the first half of the fiscal year, but we welcome the measures that were taken to attain the desired fiscal outcome when it became clear that original targets could not be met. If revenues do fall short of the targets, we would urge the authorities to take additional measures. In addition, we hope that monitoring of expenditure has improved, so that the check float is reduced.

Finally, we welcome the authorities' continued commitment to reaching the equilibrium exchange rate by mid-1988, and their acceleration of the monthly rate of real depreciation. The exchange rate during the period of adjustment toward equilibrium is extremely important to economic development, as is the restoration of a sustainable balance of payments position by the early 1990s. There is a difference of opinion as to the exact level of the equilibrium rate, and the parallel market rate is probably not a good proxy, for the reasons cited by other speakers. Nonetheless, the current rate is clearly not yet appropriate, as exemplified by the own-exchange and export retention schemes, import restrictions, etc. The rate of depreciation necessary to reach the equilibrium rate is to be considered in the next review, since the original monthly depreciation schedule applied only to the first year. While we recognize the political sensitivities toward an accelerated rate of depreciation, the current monthly depreciation schedule may not produce the equilibrium rate by mid-1988, and without such an acceleration there are serious risks to the program. Experience, as we discussed in the recent conditionality review, has shown that an approach to adjustment that is too gradual may not produce the desired response--and hence a more accelerated move toward a realistic exchange rate in the coming months could encourage additional improvements in the economy. Such depreciation should be accompanied by appropriately tight fiscal and monetary policies, and by the ongoing efforts to liberalize the domestic price and trade regime, reduce the own-exchange and export retention schemes, and eliminate supply bottlenecks.

A corner has been turned in Tanzania--a very significant corner. Yet economic problems remain, and we urge the authorities to continue their efforts, as these can only benefit the country. We support the proposed decisions.

Mr. Salehkhou made the following statement:

I support the proposed decisions on the 1987 Article IV consultation, and the review and request for a waiver under the current stand-by arrangement.

The medium-term economic recovery program, which was designed in line with Executive Board recommendations, received wide support from the international community. The program aimed at beginning the sustained revitalization of the economy, and at achieving positive growth of per capita incomes, with a low rate of inflation and a viable external position. Given the gravity of Tanzania's economic and social situation, which had developed over a number of years, it is heartening to note that all the performance criteria except one were met. The preliminary data also suggest that the objectives of the program are achievable, and the authorities should be commended for their vigorous efforts in implementing comprehensive adjustment measures, mostly to an extent beyond those envisaged under the program. With favorable weather and the successful implementation of the appropriate measures, the overall economic and financial performance of Tanzania improved significantly, especially in the second half of the program year 1986/87, but the magnitude of the problems facing the economy ensures that the momentum of the adjustment must be maintained in the years ahead. Measures should however be implemented gradually, and should be spread over a sufficiently long period of time, to mitigate the adverse social and political impact of the adjustment.

In 1986/87 GDP is expected to grow in line with the program objective of 3.5 percent, mainly owing to a significant increase in agricultural production, although industrial output failed to recover. Favorable weather and the provision of further incentives to producers through considerable adjustments to exchange rates and producer prices made a substantial contribution to this end, but shortages of essential imported inputs and spare parts, caused by shortages of foreign exchange, resulted in the stagnation of industrial output.

The rapid move toward a realistic exchange rate is the most important achievement of the authorities. The Tanzanian shilling, targeted to depreciate by 1 percent a month under the program, was actually devalued by an average rate of 3 percent during the period between July 1986 and March 1987. This helped the authorities to narrow the spread between the official and parallel market rates, and undercuts the staff's assertion on page 27 of its report that "the current pace of exchange rate adjustment is not sufficient to ensure adequately rapid progress toward the attainment of an equilibrium rate by mid-1988." I continue to doubt whether the parallel market rates are a credible measure for determining the equilibrium rate, and fully share the authorities' view in this respect. Should the staff insist on its view, I wonder how the sharp appreciation of this equilibrium rate in the last quarter of 1986--described on page 18 of the staff report--can be justified.

Similar doubts can be extended to the use of "import license applications" as an indicator for determining the extent of the exchange rate overvaluation, since the volume of these applications could be influenced by administrative or speculative motives.

More generally, a heavy reliance on monetary policies, particularly exchange rate measures, does not necessarily remove the structural imbalances in the economy, even in the major industrial countries with well-established money markets.

Further increases in the pace of exchange rate adjustment, especially in developing countries, are most likely to accelerate inflation, which in turn leads to a further increase in government expenditures and deficits, and significant recourse to the banking system for financing. This risks the rejection of the whole adjustment process, as was the case in Zambia. Moreover, I tend to agree with Mr. Abdallah and his authorities that the program is on track, since the current account deficit is now estimated to have been reduced by 49 percent, while the capital account has turned into a surplus following successive years of net capital outflows; in addition, there is in any case no success story associated with Fund policy in this area.

In sum, taking into account the authorities' commitment--as stated in their letter of intent--to the achievement of an equilibrium exchange rate on schedule, and to the observance of the performance criteria established in the program, I strongly share the authorities' misgivings regarding the need for a further acceleration of the exchange rate adjustment.

The coverage of exchange rate questions has recently increased in staff reports. Given the sensitivity of such matters in all member countries, including the developing ones, could the staff elaborate on the wisdom of discussing so openly such matters in the staff reports and in the Board? My understanding was that exchange rate matters were to be treated in a more confidential manner, and I am concerned that if this practice continues or expands, member countries could become reluctant to discuss exchange rate matters as frankly with the staff as they used to. The staff should be encouraged to think of more appropriate and confidential means of communicating such sensitive information to the Board.

Price incentives played an important role in the recovery of agricultural output in 1986/87, and I welcome the authorities' intention to further increase agricultural producer prices in real terms. Industrial output is expected to pick up in early 1987 with the further provision of required inputs through external financial assistance, and the enchancement of the export retention scheme and own-exchange scheme.

Fiscal, monetary, and credit policies were prudently implemented, strengthening the country's external position and containing inflationary pressures; measures taken to increase revenue and reduce expenditures were steps in the right direction; and it is encouraging that the overall budget deficit and net bank financing to the Government in the first half of 1986/87 were below the program ceilings. Among other performance criteria, total domestic credit expanded above the established ceiling owing to the large crops of cotton and maize and delays in purchasing and payments by the marketing boards, which generated a further increase in the financing requirement.

The estimated external current account deficit for 1986/87 is lower than envisaged, and the overall balance of payments deficit is projected at US$256 million, as compared with a programmed level of US$439 million. Tanzania's improved balance of payments position helped the authorities to reduce external arrears below the targeted level. Gross international reserves also increased from the equivalent of 0.8 weeks of imports at the end of 1985, to 2.4 weeks of imports at end-December 1986.

In concluding, the authorities have successfully contained the increase in the rate of inflation as a result of the improved availability of domestic food crops, despite the substantial adjustment in exchange rate and producer prices.

Mr. Rousset made the following statement:

I join other speakers in expressing satisfaction with the results achieved by the authorities, and with the determined implementation of their adjustment program. I support the proposed decisions.

The measures introduced over the past 12 months to improve resource allocation and enhance production incentives have yielded very encouraging results, particularly in the agricultural sector. As a result of adequate financial policies, the inflation rate has been substantially reduced, and the current account deficit is now forecast to be lower than originally anticipated.

The results of the adjustment program are indeed very encouraging, but there is still a long way to go, since prospects remain extremely difficult in the external sector; external viability will depend on the continued implementation of policy reforms, and we encourage the authorities to pursue this effort.

While increased exports will stem mainly from the recovery of traditional agricultural crops, the recent discussions between the authorities and the staff have rightly stressed the need to focus on revitalizing the export of manufactured goods, an area in which the results have been disappointing so far. This recovery will depend heavily both on the industrial sector's capacity to import the spare parts and inputs that it needs, and on its ability to produce competitively for the local and export markets.

This brings us to the pace of the exchange rate adjustment--a subject on which there is a clear divergence of views between the Tanzanian authorities and the staff, and I would think that the right position is probably somewhere between these two positions. However, as Mr. Abdallah noted, a decision on such a matter cannot be taken on technical grounds alone. It could have very heavy political consequences, which could affect the adjustment process itself much more seriously than would a temporarily insufficient pace of adjustment. I therefore wish to encourage both parties to approach this issue in a very open way during the coming discussions in Dar es Salaam, and to do their utmost to reach a feasible solution.

I also hope that these discussions will lead to the conclusion of the negotiation on a first arrangement under the structural adjustment facility.

Mr. Lundstrom made the following statement:

Tanzania's performance under the current stand-by arrangement is impressive, and the authorities are to be congratulated on the progress achieved. Three factors stand out. First, the Tanzanian authorities have implemented, in a timely fashion, the adjustment measures envisaged under the stand-by arrangement. Second, with one exception, all indicative targets and performance criteria for end-September 1986 and end-December 1986 have been met. Third, the main objectives of the program remain achievable.

The program commenced after long and difficult negotiations, and it is, therefore, particularly gratifying to observe the success achieved so far. Some of Tanzania's neighboring countries might benefit from studying this case of cooperation between a member country and the Fund, after a period during which the country opted for a "go it alone" policy.

Since most aspects of Tanzania's economic policies and developments have already been covered by previous speakers, I can limit myself to some remarks on the most crucial part of the adjustment strategy: exchange rate policy.

The program envisages the gradual achievement of an equilibrium exchange rate by mid-1988. To this end the shilling was initially depreciated by 58 percent; subsequently, in accordance with a performance criterion, the real effective exchange rate of the shilling was to be depreciated by 1 percent each month. In the period July 1986-March 1987, however, the shilling has been adjusted in real effective terms by an average of 3 percent a month. By end-March this year the depreciation was therefore about 18 percent larger than envisaged under the program, an achievement that should be commended. These developments are described on page 27 of the staff report, where it is said that the authorities have "accelerated somewhat" the adjustment of the exchange rate. To me, this seems something of an understatement. Furthermore, the staff has indicated to the authorities that the current pace of the exchange rate adjustment was not sufficient to ensure "adequately rapid progress toward" the objective of attaining an equilibrium exchange rate by mid-1988. But the staff does not say that the current pace of exchange rate adjustment is insufficient to ensure the attainment of an equilibrium rate by mid-1988. The staff's language at this point may create some confusion, and a clarification would be welcome.

The shilling is still misaligned, calling for correction; but the optimal path for attaining the equilibrium objective is open to discussion. From a purely economic standpoint, a rather nongradual corrective action might be preferable. However, overly sharp action might imply social and political ramifications, possibly impairing further exchange rate adjustment and thereby jeopardizing the whole program. Mr. Abdallah's comments on the dangers of unduly accelerated depreciation deserve attention. Like Mr. Foot, I think that trade-offs should be further explored between the rate of devaluation and the need for monetary and fiscal action, and that alternative paths to equilibrium should be outlined. I support the proposed decisions.

Mrs. Filardo said that she joined previous speakers in commending the authorities for the progress achieved in the implementation of the program, and supported the proposed decisions regarding the 1987 consultation and the review and request for the waiver under the stand-by arrangement. The Tanzanian authorities had implemented all the measures envisaged in the program and had complied with all but one of the performance criteria, a failure that was to some extent justified. The authorities should be encouraged to continue the implementation of sound macroeconomic policies and structural reforms; in that context, the future evaluation of the policy framework paper and the structural adjustment arrangement would be welcome.

Mr. Binay made the following statement:

Because Tanzania was a latecomer to the adjustment process, and the implementation of the adjustment program has also been slow, Tanzania has not yet taken all the measures that will be required to straighten out its economy. The two major problem areas are the overvalued real exchange rate and its consequences, and the negative real interest rates.

The staff report, by comparing the official and parallel market rates, and examining the sustained own-exchange scheme, shows that even though the real exchange rate has depreciated by over 50 percent under the present stand-by arrangement, it is still greatly overvalued.

Given the export retention system and the own-exchange scheme, much of the foreign exchange for imports may be supplied from channels which are fed by smuggling carried on at unofficial parallel market rates. Using official rate prices as a basis for inflation figures when the actual import prices of industrial raw materials are being set by unofficial parallel market rates will cause inflation to be grossly underestimated. And as the Government prices import-intensive manufactured goods on the basis of official exchange rates, while letting manufacturers import goods with their own funds acquired from the parallel foreign exchange markets or by smuggling, the only way that manufacturers can make a profit is by selling their production at parallel market prices. This situation leads to the under-reporting of capacity utilization figures, encourages the evasion of corporate income taxes, and will even promote the flight of capital if investment opportunities in the country are limited, or if the accumulation of funds is questioned. For all these reasons, we should encourage the Tanzanian authorities to reach an equilibrium exchange rate at an earlier date than is now planned.

The negative real interest rates attached to bank financing still provide parastatals with a hidden subsidy which hampers the efficient allocation of resources, even though almost all subsidies to parastatals were abolished in recent months. Negative real interest rates also boost demand for consumer durables and gold, which damages the Tanzanian economy; the Tanzanian authorities' intention to bring real interest rates to positive levels by July 1, 1987 is therefore welcome. Even that achievement will however necessitate caution in accepting the official estimates of inflation.

In sum, this chair welcomes the Tanzanian authorities' determination to speed up the first stage of their adjustment program, and we support the proposed decisions.

Mr. Jiang stated that the Tanzanian authorities have implemented firmly and with remarkable success the adjustment measures envisaged under the stand-by arrangement; furthermore, they intended to maintain that level of progress for the remainder of the program, and for the medium term. Taking into account Tanzania's specific situation, and especially its political and social realities, he supported the proposal that the Fund take a flexible stance toward some adjustment criteria--such as the exchange rate--particularly since the depreciation of a currency was not as effective a tool in a planned economy as it was in a market economy.

Mr. Hospedales made the following statement:

I generally accept the thrust of the very balanced staff appraisal of recent economic developments in Tanzania, and the review under the stand-by arrangement. Tanzania's satisfactory record of policy continuity and implementation, and commitment to the comprehensive medium-term recovery program, have been impressive; wide support has also been received from the international financial community. The program has in consequence yielded fundamental improvements, and we concur with the staff's view that this phase of adjustment has been relatively successful. But, while economic growth in Tanzania could continue and increase, progress can be assured only if the macroeconomic and structural policy framework remains intact over the medium term, and support from the international financial community through exceptional financing and debt relief will continue to be critically important.

Mr. Abdallah is correct to question the staff recommendation for a further major exchange rate adjustment. The Tanzanian authorities have shown considerable courage over the past 12 months by pursuing an active exchange rate policy which resulted in the real exchange rate depreciating by approximately 70 percent; we are all aware that the determination of a realistic exchange rate, especially in this transitional phase of the Tanzanian economy, will be a delicate process, and that the sensitivity of domestic prices to exchange rate movements in an economy as open as Tanzania's ensures that any acceleration of inflation could have far-reaching social and political implications. In addition, faster exchange rate adjustment may not elicit the envisaged benefits, given the heavy concentration of the export trade in primary commodities. A degree of caution is therefore necessary; and the Tanzanian authorities are correct to stabilize, where possible, the overall economic framework--thus allowing the gradual absorption of the large adjustments that have been taking place during last year. Given the authorities' record of adjustment, their commitment to the current exchange rate policy and to keeping it under continuous review is therefore well conceived. In addition, I associate myself with Mr. Salehkhou's remarks on the sensitive and confidential aspects of the issue, and look forward to the staff's response. We support the proposed decisions.

The staff representative from the African Department said that from July 1986 to March 1987 the authorities had depreciated the exchange rate on average by 3 percent a month in real terms, a 17 percent overfulfillment. It had been agreed that the authorities would remain 17 percent in excess of the 1 percent target between March 1987 and June 1987. During that period the continuing depreciation would therefore be only 1 percent a month. The staff's understanding had been that the authorities would be willing to go considerably beyond the existing 17 percent overfulfillment, and go back to a 3 percent rate of depreciation every month in real terms, in which case, the overfulfillment would increase by 2 percentage points a month.

The equilibrium exchange rate would obviously depend on the financial program for 1987/88, the staff representative continued, as it depended partly on the character of fiscal and monetary policy; it was also dependent on the level of external assistance. The outcome of the July Consultative Group meeting in Paris would therefore substantially influence the balance of payments prospects for 1987 and 1988, and would quite directly influence the "equilibrium exchange rate" by mid-1988. A depreciation of 3 percent a month in real terms would probably take the exchange rate to about 105-110 shillings to the dollar by mid-1988, which would probably be slightly below an equilibrium exchange rate, defined as an exchange rate that could be sustained without restrictions for balance of payments purposes.

Based on the existing exchange rate, producer prices had been increased as far as possible, the staff representative commented. Indeed, the limits of feasibility might have been exceeded, as the 1987 producer price of maize would probably imply a fairly significant deficit for the Grain Marketing Board. That outturn might also occur in the cases of cotton and tobacco, depending on the relevant world market prices. In any event, producer prices were on the high side, given the current exchange rate, which meant that in the short run incentives could be improved only through changes in the exchange rate. While the efficiency of the Grain Marketing Board could be improved, that would take time; the main cost incurred by the Board was in fact interest on its bank overdraft, which was likely to increase with higher interest rates.

The parallel market rate had stayed more or less constant from 1986 up to the first quarter of 1987, the staff representative explained, after which it had appreciated significantly, mainly as a result of expectations that import support would start flowing in, and in particular, that the first disbursement of the World Bank loan would take place. The parallel market rate had started to depreciate again in early 1987, more or less back to the mid-1986 level, probably because external assistance had not in fact flowed in as rapidly as expected. External assistance had then subsequently arrived, and the parallel market rate had again appreciated significantly over the past two or three months.

There was no shortfall in external assistance in 1986/87, the staff representative from the African Department said, even though external assistance had arrived more slowly than expected. It was much too early to judge aid levels for 1987/88, as the Consultative Group meeting that would largely determine the amount of external assistance had not yet taken place.

The staff representative from the Exchange and Trade Relations Department said that the Board had in past meetings declared its interest in adequate and open treatment of all aspects of exchange rate policy, especially in those cases where exchange rate policy was the central part of the adjustment process. Obviously, the degree of openness would vary with the risks of triggering adverse behavior patterns, but a much broader discussion was possible where there were preannounced exchange rate targets and formula-type adjustments.

Mr. Abdallah thanked Executive Directors for their comments on the Article IV consultation and the review of the stand-by arrangement.

The staff in general treated parallel markets as though they actually existed, Mr. Abdallah noted. In reality, however, there was no market, merely a group of individuals whose price for foreign exchange varied widely at any given moment depending on an array of circumstances. Thus, comparing the "parallel market price" in 1982 to its level in 1983 institutionalized something that by definition existed outside institutions, and that was also subject to the huge fluctuations and enormous volatility inherent in such arrangements.

Many Executive Directors had begun to appreciate the sensitivity of all matters connected with the exchange rate, Mr. Abdallah continued, and that was very encouraging. On some matters the Tanzanian authorities did not view limits on exchange movements as "restrictions" at all. For instance, foreign exchange at the official rate was not allocated to people who sent their children overseas for education; and there was no intention of providing foreign exchange for that purpose in the foreseeable future, as it was government policy that Tanzanians should be educated within the country. Only to the extent that the Government felt that there was a need for people to be sent abroad would the Government itself provide the necessary foreign exchange, either via bilateral donors or through some other mechanism. His authorities therefore joined with many Executive Directors in urging the staff to show pragmatism, flexibility, and openness on the issue of the exchange rate. He had been in Tanzania about six weeks previously and had been amazed at the major positive changes that had occurred throughout the economy, changes reflected in both economic management and economic prospects, as people had seen the benefits of the program. Credit for those positive changes could be shared by the Fund, the World Bank, bilateral donors, the authorities, and even the weather--but the result had been a new momentum, and all the parties involved should ensure that Tanzania stayed on that course by dealing pragmatically and flexibly with the situation.

The Acting Chairman made the following summing up:

> Against the background of a progressive deterioration in Tanzania's economic situation over a number of years, Directors commended the recent reorientation of economic policies, especially the adjustments in the exchange rate, interest rates, producer prices, and domestic financial policies. Directors praised the authorities' determination to implement additional adjustment measures as required. They pointed out that some of the favorable effects of this new policy orientation are already evident, and that the recent and prospective economic performance of the Tanzanian economy was encouraging. While Directors agreed with the staff's favorable assessment of these developments in the Tanzanian economy, they noted that the adjustment efforts of the past 12 months would have to be maintained.
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> A number of Directors noted that the medium-term balance of payments outlook remains bleak, and that despite the major exchange rate adjustments already effected, the exchange rate of

the Tanzanian shilling remains substantially overvalued. These Directors wondered whether the present pace of depreciation would be too slow to produce an equilibrium rate within the time frame of one year, as planned. Thus, they stressed that the pursuit of a realistic exchange rate is necessary for providing the required incentives to the export sector, and for the efficient allocation of resources unencumbered by restrictions and controls on the external sector. Several other Directors noted the Tanzanian view that there was an important time lag between the exchange rate depreciation and the supply response, and there was a need to emphasize the immediate removal of supply bottlenecks. All speakers stressed the importance of caution and flexibility in the area of exchange rate adjustment and were sensitive to the technical difficulties of determining the equilibrium rate of exchange. Directors also noted that further adjustments are required in interest rates, and that the decontrol of domestic prices had not been completed. They commented that the achievement of positive real interest rates depended significantly on the underlying inflation rate meeting official expectations. They commented that the rate of inflation had not accelerated despite the major exchange rate depreciation and adjustments in administered prices.

Directors welcomed the change in fiscal stance adopted by the authorities, and their willingness to take additional revenue and expenditure measures to keep the fiscal program on track. However, they stressed that the underlying fiscal deficit and bank financing of the budget still remain large, and that these should be reduced to more sustainable levels. It was noted by a number of Directors that a slower pace of action in the exchange rate field would inevitably mean that other aspects of the program--in particular fiscal and monetary policy, as well as the general decontrol of the economy--would need to be strengthened in order to achieve the overall domestic and external targets of the program. Directors supported the authorities' emphasis on the rehabilitation of existing capital assets rather than new capital projects, and stressed the need to give the highest priority to the rehabilitation of the infrastructure, the deteriorated portion of which was a major constraint on the recovery of economic activity and external trade in particular.

Directors noted that the problems faced by the marketing boards were largely due to inadequate pricing and marketing policies. They emphasized that in order to avoid large financial losses being incurred by the export marketing boards, a realistic exchange rate and producer prices for export commodities, set in light of developments in world market prices, were essential. Regarding domestic food crop marketing, Directors commended the liberalization effected thus far, and welcomed an early reform of the role and operations of the crop marketing board. The priority now attached by the Tanzanian authorities to agricultural development and their objective of self-sufficiency in food were welcomed.

Directors expressed satisfaction at the level of support Tanzania obtained for its recovery efforts from the international donor community. While recognizing the importance of continued external assistance, Directors stressed the need for Tanzania to continue and strengthen its adjustment efforts so as to best utilize the support provided.

Finally, it was also emphasized that prompt policy implementation by the Tanzanian authorities, and a balanced combination of pricing, fiscal, and structural policies, would help to permit the introduction of an arrangement under the structural adjustment facility in the near future.

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

The Executive Board then took the following decisions:

Decision Concluding Article XIV Consultation

1. The Fund takes this decision relating to Tanzania's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1987 Article XIV consultation with Tanzania, in the light of the 1987 Article IV consultation with Tanzania conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Tanzania maintains restrictions on payments and transfers for current international transactions (described in SM/87/103) in accordance with Article XIV, Section 2, except that the exchange restrictions evidenced by external payments arrears are subject to approval under Article VIII, Sections 2(a) and 3. In the circumstances of Tanzania, the Fund grants approval for the retention of these restrictions until the next Article IV consultation with Tanzania, or the completion of the second review under the stand-by arrangement for Tanzania set forth in EBS/86/183, Supplements 1 and 2, whichever is earlier.

Decision No. 8593-(87/76), adopted
May 20, 1987

Review Under Stand-By Arrangement

1. Tanzania has consulted with the Fund in accordance with paragraph 4 of the stand-by arrangement for Tanzania (EBS/86/183, Supplements 1 and 2) and paragraph 5 of the letter of the Minister of Finance, Economic Affairs, and Planning, attached to the stand-by arrangement, in order to review policies, establish performance criteria for the first half of 1987, and reach understandings subject to which Tanzania may make further purchases under the arrangement.

2. The letter dated April 27, 1987 from the Minister of Finance, Economic Affairs, and Planning (Attachment I to EBS/87/88) shall be attached to the stand-by arrangement for Tanzania, and the letter dated August 8, 1986 shall be read as supplemented by the letter of April 27, 1987.

3. Accordingly, Tanzania will not make purchases under the stand-by arrangement that would increase the Fund's holdings of Tanzania's currency in the credit tranches beyond 25 percent of quota or increase the Fund's holdings of that currency resulting from purchases of supplementary financing beyond 12.5 percent of quota during any period in which the data at the end of the preceding period indicate that:

(i) the ceiling on changes in total domestic credit and in net domestic assets of the banking system as specified in paragraph 13 of the attached letter dated April 27, 1987; or

(ii) the ceiling on changes in the net bank credit to the Government as specified in paragraph 11 of the attached letter dated April 27, 1987; or

(iii) the ceiling on changes in bank credit to the seven marketing boards as specified in paragraph 13 of the attached letter dated April 27, 1987; or

(iv) the ceiling on the overall budget deficit as specified in paragraph 10 of the attached letter dated April 27, 1987, is not observed.

4. The Fund decides that the first review under paragraph 4(b) of the stand-by arrangement is completed and that, notwithstanding the nonobservance of the schedule for the completion of the review in that paragraph and in paragraph 5 of the letter dated August 8, 1986, the nonobservance of the ceiling on overall domestic credit for end-December 1986, and the applicability of the performance criteria specified under (3) above for end-March 1987, Tanzania may proceed to make purchases under the arrangement.

Decision No. 8594-(87/76), adopted
May 20, 1987

2. AUSTRIA - 1987 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1987 Article IV consultation with Austria (SM/87/97, 4/29/87). They also had before them a background paper on recent economic developments in Austria (SM/87/100, 5/7/87).

Mr. Schneider made the following statement:

Following the 1987 Article IV consultation discussions with the Austrian authorities last February in Vienna, the staff has prepared a concise set of papers together with a well-balanced assessment of developments in and prospects for the Austrian economy.

While at the beginning of 1986 world economic prospects still looked promising, particularly in view of the marked decline in the price of crude oil, the actual performance of the world economy in 1986 has been disappointing. Counter to earlier expectations, real growth rates were fairly moderate; current account imbalances among major countries increased further, as did protectionist pressures; unemployment rates remained at unacceptably high levels; and the problem of the international debt crisis remained unsolved.

The deterioration of real economic conditions will tend to hamper reasonable solutions in these areas, because even countries with balance of payments surpluses cannot be expected to expand their demand to an extent that would jeopardize the goal of price stability and the process of budget consolidation.

In view of the steadily increasing world economic interdependence, Austria has a strong interest in aligning itself to a greater extent with the European Communities, and its bonds with the EC are closer than ever before. Therefore, Austria's competitiveness can only be maintained if the same conditions for trade in goods and services that exist within the EC also prevail between the EC and Austria. This is all the more important, since the EC member countries intend to complete the "internal market" of the EC by 1992.

In 1986, the basic economic pattern in Austria has not essentially differed from that of other industrial countries. The extent of international interdependence, which virtually rules out the possibility of independent economic strategies for smaller economies, also demonstrates that short-term economic policy measures adopted with the aim of swimming against the tide are bound to collide with balance of payments constraints. In Austria, the basic pattern consisted of a marked slowdown in export growth and only a modest growth of private consumption. In spite of clearly rising real incomes at a time of declining inflation rates and consequently lower prices, the cautious attitude of consumers led to a sharp increase in the personal savings ratio.

The effects of sluggish exports on industrial production are more serious than was assumed only a few months ago. Industrial employment in Austria declined--particularly in the second half of 1986--and on the basis of the latest available data it appears that the industrial sector has entered a phase of stagnation. The unemployment rate rose to over 5 percent in 1986 and is expected to reach 5.9 percent this year. Such an unemployment figure is considered to be exceptionally high by Austrian standards and represents one of the most serious problems facing the authorities.

Finally, while the declining inflation rate still remained somewhat above the one in Germany, due mainly to increases in the Austrian "closed sector" prices, the development of unit labor costs followed an almost parallel path in both countries. Furthermore, the current account balance in 1986 recorded a slight surplus. Basically, both developments are the effects of the slump in crude oil prices, the decline in the dollar exchange rate, and the persisting low prices for primary products.

As the staff rightly stresses, the hard currency policy remains the cornerstone of Austria's economic strategy of maintaining price stability via the exchange rate policy. However, this policy ought not to be interpreted in too narrow a sense because it is of primary importance for the monetary authorities to establish a clearly defined framework for economic policies, as well as to secure the basis for stable exchange rate expectations. In the last few years it has been successfully demonstrated that no realistic alternative exists to the hard currency policy.

However, one of the most important preconditions--at least in the medium term--is a relative harmony of the macroeconomic fundamentals with those of other hard currency countries, in particular Germany. In this regard, a matter of concern is the divergence in fiscal performance which needs to be corrected. In order to maintain credibility and confidence, the stability of the basic monetary conditions under given exchange rate objectives plays a very important role in the two main tasks of Austrian economic policy today: consolidating the budget and restructuring the economy. These two major goals have been duly recognized by the new Government in the detailed coalition agreement concluded between the two main parties after the parliamentary election in November 1986.

It is of highest priority for the Austrian authorities to consolidate the federal budget in the medium term by gradually reducing the deficit to 2.5 percent of GDP by 1992 from a projected deficit of 4.9 percent of GDP for 1987, and to encourage structural adjustment in Austrian industry--especially nationalized industries.

Since the new Government was only formed in January 1987, it will take some time before the measures outlined in the coalition agreement and highlighted in the staff report can be implemented. Close cooperation with the "social partners" will be required in order to succeed with the envisaged structural changes.

Patience and courage will be needed to convince the different interest groups that fundamental changes are necessary in the interest of the public at large, to maintain a competitive economy and to avoid higher social costs that eventually will have to be paid as a price for delayed adjustment actions.

Turning briefly to the less buoyant economic outlook for 1987 implied by the most recent forecasts, the Government does not at present see a need to change the budget for 1987 or to activate the contingency budget. Additional expenditure on account of higher unemployment should be financed largely by the unemployment insurance system itself, without any significant effect on the overall budget deficit. Similarly, budget revenue is not immediately and fully affected by the slowing in economic activity presently foreseen, as wage tax revenue depends on already negotiated wage incomes, and profits taxes relate to business incomes of the two previous years; VAT receipts are not directly affected as the slower growth emanates mainly from slower exports and investment expenditure. With preparations for the 1988 budget getting under way, the Government has reaffirmed its intention to lower the net deficit in that year to 4.4 percent of GDP, as envisaged by the consolidation program.

With regard to the nationalized industries, the coalition partners have just reached agreement on the already announced multiyear assistance package. The holding company of the nationalized industries (OeIAG) is to receive government guarantees for principal and interest on any borrowings after March 1986 totaling up to S 33 billion; in addition, S 8 billion is to be raised from the sale of assets, both by OeIAG--with the sales proceeds accruing to OeIAG--and by the Government--including the partial privatization of two publicly owned banks and Austrian Airlines--with the sales proceeds accruing to the budget. The agreement also mandates cutbacks in certain pension benefits granted by OeIAG, and calls for wage restraint in enterprises benefiting from public assistance. A final element of the agreed new package is the earmarking of S 8 billion in support for technological innovation by way of long-term credits and grants; funding of this program is to be secured through the partial privatization of publicly owned electricity companies.

In sum, economic policies have become more and more complex in recent years. Economic conditions are changing rapidly, raising questions and problems that require decisive actions. To this end, policymakers at all levels are confronted with a continuous challenge in coping with this situation.

Mr. Grosche made the following statement:

In 1986, even though economic growth in Austria turned out to be smaller than expected, the economy's overall performance has remained above the average of the smaller industrial countries. The "hard currency policy"--which remains the cornerstone of Austria's economic strategy--has served Austria well, and I fully share the staff's positive assessment of that policy.

Unfortunately, in real life there is virtually no economic picture without flaws that continuously challenge policymakers. There are some disquieting features in Austria, which if left unchecked could easily accumulate into a most serious problem in the future. The most troubling issues are the large and persistent federal deficits, which are the result of underlying structural problems in the economy, particularly those associated with the nationalized industries.

As regards fiscal policy, the substantial differences between Austria and Germany could, if not lessened, eventually weaken Austria's external position vis-à-vis its main trading partner, and erode the basis for the hard currency strategy. As illustrated by Chart 4 of the staff report, the failure to control the budget deficit between 1981 and 1983, and its slow reduction since then, have heavily constrained fiscal policy. The Austrian authorities have however now set up a medium-term budget consolidation program, under which the deficit will be gradually reduced to 2.5 percent of GDP by 1992, and this is encouraging. The authorities' intended cut of one third in subsidies over that period is also laudable, though not easily accomplished. I welcome the simplifying and equalizing effects of the planned tax reform on the tax system. Nonetheless, I share the staff's skepticism about lower income tax rates, resulting in a planned reduction of almost 2 percent in the ratio of budget revenue to GDP, while budget deficits are only slowly being reduced.

Pension costs induced partly by demographic trends are another key issue which the Government has already attempted to tackle. The 1985 reform, which increased contributions and reduced payments by changing the indexation rates and the calculation base, has slowed but not reversed the increase in the pension funds' deficit. I therefore welcome the follow-up reform of the pension insurance system planned for 1989.

Disturbingly, the various attempts over several years to reduce the losses of nationalized industries have never turned out as successfully as intended. Nonetheless, the reorganization of the nationalized industries under the roof of a new company, to be managed like a private enterprise, seems to be a promising step. I hope that the business-oriented management of this company will be better placed to address the underlying weaknesses of the nationalized industries by both strengthening management and restructuring production. I am also encouraged by Mr. Schneider's statement that the Government has concrete plans for the selective privatization of public enterprises.

The envisaged path of fiscal consolidation, and the need to keep Austria's industries competitive under rapidly changing economic conditions, require close cooperation among the social partners. The staff report mentions on page 12 that the Government and the social partners are already discussing methods of sharing the burden of adjustment. This is a positive indication that appropriate solutions will be found, including the need for public sector employees and retired personnel to live within current real income levels, without further increases in the near future.

The unemployment rate at 5.2 percent is currently much lower than that of many other European countries, but by past Austrian standards it is now very high. Austria was able to maintain low unemployment during the second half of the 1970s, against the European trend, mainly due to a generally expansionary fiscal policy. However, as the authorities accept, this strategy is no longer applicable. Although there are no easy answers to the unemployment problem, a variety of labor market policies could alleviate rising unemployment. Such policies could include enhanced training and retraining schemes, together with measures to stimulate the mobility of labor.

Finally, I welcome the new banking law, and note the first signs that the banks are seeking to increase their capital/asset ratios. But like the staff, I have some doubts as to whether the extension of the existing agreement on "no-competition-on-interest rates" is really conducive to the desired strengthening of the banking sector.

Mrs. Filardo made the following statement:

Despite adverse world economic developments, Austria has simultaneously maintained economic growth, price stability, relatively low unemployment, and a satisfactory positive external sector. These positive results stemmed from the consistent coordination of economic policies, including particularly the social partnership and the hard currency policy. Against this background, the focus in the Austrian economy should be on a medium-term perspective, taking into account both the favorable existing framework and current structural reforms, as well as the built-in rigidities that could obstruct well-balanced results in the future.

The staff report stresses that federal financing remains the main area of concern. While fiscal policy is a cornerstone of macroeconomics, it requires coordination with other policies, and correspondence with economic fundamentals. The staff however appears to consider fiscal consolidation a panacea for Austria's economic problems; there is also an apparent contradiction in the staff's views on the fiscal deficit envisaged for 1987, and the pace at which the deficit should be reduced in the future. Table 14 of the background paper indicates that the federal budget deficit increased from 4.1 percent of GDP in 1982 to 5.1 percent of GDP in 1986; it peaked in 1983, and has since averaged approximately 4.5 percent. The main items affecting the deficit are transfer payments, unemployment benefits, transfers to enterprises, and the interest on debt. These result largely from the Government's structural reforms in public enterprises such as mining and steel, aluminum, and others. While the background paper acknowledges the difficulty of gaining a comprehensive overview of the current budgetary implications of all government assistance to enterprises--because the detailed account of expenditure allocations does not permit the identification of subsidy payments and the subsidy report is available only with a three-year lag--the figures in Table 16 of the paper indicate that total assistance to industrial and agricultural enterprises has steadily increased from S 4.9 billion in 1977 to S 17.1 billion in 1986. This is a 249 percent increase in ten years. Table 17 of the same background paper shows that federal government subsidies have increased steadily, and direct subsidies to enterprises have doubled in six years. In this context, a deficit of this size becomes a matter of questionable significance, while the authorities' desire to redress the fiscal deficit may be affected by the rigidities of expenditures on the items mentioned above. Further questions relate to the function of public expenditure and investment, versus the role actually played by private consumption and investment. Figures for 1986 show a substantial reduction of private investment over 1985, notwithstanding an increase of disposable income and savings. The public sector has not crowded out the private sector--on the contrary, the private sector has not crowded in.

These considerations might imply new challenges for fiscal policy--specifically, the need to aim at a medium-term fiscal deficit reduction. Thus the apparent contradiction in the staff report lies in the claim in the staff appraisal that "the Federal budget for 1987 does not yet represent a decisive move toward fiscal consolidation," and the subsequent statement that "in view of the need to curb the growth of government debt and the requirements of the hard currency policy, a fiscal consolidation along the envisaged path would seem appropriate." The staff could perhaps comment on this apparent contradiction, and explain whether it considers the deficit important, given the structural reform that is taking place, indicating how the authorities could solve these problems. Mr. Schneider could comment on his Government's analysis of structural reforms, including an explanation of the long lags of government data on subsidies. He might also discuss any plans that might exist which analyze the cost of those structural reforms.

Mr. Templeman made the following statement:

Once again we can commend the authorities for Austria's generally favorable economic performance, which is largely the product of prudent financial policies and of some structural reforms undertaken in recent years. The staff again identifies the key role played by the "hard currency" and "social consensus" policies, reflecting the close economic ties between Austria and the Federal Republic of Germany. Indeed, three recent examples in the Board--Denmark, Belgium, and now Austria--have clearly illustrated the interaction of members' economies on one another and represent a useful object of our surveillance efforts.

The success of Austria's hard currency policy and the pegging of the schilling to the deutsche mark clearly depend on limiting the differentials in fundamental economic developments between the two countries. Austria has been quite successful so far in doing so as regards price and cost performance, and in maintaining a fairly strong current account position in the balance of payments, although not one comparable to the very large German surpluses. However there are a few areas, notably fiscal performance, which show a potential for undermining the basic hard currency policy.

The continuing large federal deficits, in the range of 4 percent-5 percent of GDP, and the somewhat lower general government deficits, remain a cause for concern. The medium-term fiscal objectives set by the new coalition Government are, therefore, very welcome. Of course, it is still rather early to expect much detail about how the reduction of the federal deficit to 2.5 percent of GDP by 1992, and related aims, are to be achieved. Our own concerns center mainly on the continued high tax burden and high marginal tax rates, and on the need to contain such current expenditures as interest on the public debt and transfer payments, especially with regard to the pension system and the nationalized industries.

This year's cut in the personal income tax via increased personal exemptions is welcome, but a ratio of general government revenue to GDP which will apparently not fall much below the current level of 47 percent in 1992, and a maximum marginal personal income tax rate of 62 percent, must have adverse effects on incentives to work and save. We recognize the delicate balance between reducing the tax burden and reducing the fiscal deficit, but hope that the ongoing tax reform effort will include measures consistent with both objectives.

The continued increase expected in the public debt and interest on the public debt through 1992 foreshadows a growing limitation on the discretionary element of public spending. The sensitivity analysis in the footnote to page 9 of the staff report underlines the vulnerability of the fiscal situation.

The large element of subsidies and transfers in the federal budget also presents problems, especially with regard to pensions. Pensions are a common problem in industrialized countries, as we know from our seminar last year on the long-term outlook for social expenditures. It is not clear yet what form the proposed 1989 reform of Austria's pension system might take. Additional information would be welcome.

Finally, it was our impression last year that large-scale financial assistance to the public enterprises was largely completed. Yet, it appears that a new multiyear assistance package is being considered. I would welcome some further comment on what has been happening and on the outlook. We realize, in particular, that there is to be a large increase in assistance for agricultural price support payments in 1987. It would be interesting to know why this is needed and how it relates to Austrian policy on the treatment of agriculture in the new round of GATT negotiations.

A reduction in the federal fiscal deficit should have a salutary effect on the pattern of savings and investment, by reducing public dissavings. However, there seems, on page 7 of the staff report, to be an assumption that the counterpart to lower public dissavings should be a larger current account surplus, since private savings and investment ratios are already rather high, and that a stronger current account position would allow Austria to emulate Germany's external position more closely. But, given the fairly low rate of real economic growth and the rising unemployment rate in Austria, a more desirable result of a shift in savings and investment balances following a decline in the fiscal deficit might be a somewhat higher investment ratio, rather than a buildup of current account surpluses.

The staff report points out an important link between fiscal policy and the success of the social partnership, which has been quite successful in achieving wage cost restraint in recent years. This has to do with the periodic use of fiscal support for business and labor interests, as a quid pro quo for such restraint. Yet the growing cost of servicing the public debt reduces the Government's leeway in accepting additional fiscal costs. This limitation seems to be recognized in Austria, and it is encouraging to read that business and labor seem willing to accept some of the burden of fiscal adjustment in order to foster more rapid employment growth. It would be interesting to know the initial outcome of the talks on this subject that began in March among the social partners.

The overall economic performance and outlook for Austria still seem quite favorable, notwithstanding such problems as the fiscal deficit. But relatively slow economic growth and rising unemployment, albeit at a low level by international standards, are symptoms of some underlying problems. Presumably, the new coalition government has an opportunity to address these problems more forcefully during this honeymoon period. We hope that it will do so.

Finally, given Austria's generally good economic record, and taking into account the fact that an interim report would also be sent to the Board, we can agree to a 24-month cycle for the next Article IV consultation.

Mr. Al-Assaf made the following statement:

The Austrian authorities are to be commended for their management of the economy. Economic growth has been relatively high for a number of years, and inflation has been low. The particular mix of policies selected by the authorities has clearly been consistent with the circumstances of the country. This mix has included a combination of a hard currency strategy and the social partnership for short-run demand management, while emphasizing structural change over the longer term. These policies will continue to be appropriate in 1987, although some of the emerging challenges facing the authorities will require significant flexibility. Given past evidence, the Austrian authorities should succeed in sustaining both growth and adjustment.

For the short run, the hard currency strategy means that continued convergence between Austrian and German policies remains essential. This objective has lately been complicated by the appreciation of the deutsche mark. Continued adherence to the hard currency strategy thus implies reinforced efforts to follow the projected path of fiscal consolidation, and it also implies the encouragement of wage moderation, so as to minimize the loss in competitiveness. Such outcomes are especially important, since Austria, unlike Germany, does not have the buffer of a current account surplus, and thus has less room for maneuver. The need to reduce the fiscal deficit in Austria derives not so much from its deficit being relatively larger than the corresponding German deficit, but from Austria's traditionally high investment-to-GDP ratio. This, in turn, places a premium on generating public sector savings.

In the short run, the emerging weakness in aggregate demand could possibly justify a change in the fiscal stance. Attempts to fine tune can however be self-defeating, and a stable policy stance is preferable. Furthermore, Mr. Schneider indicated that the weakening of aggregate demand is unlikely to lead to a deterioration in the public finances. I therefore agree with the authorites' intention to retain the existing budget.

As for the medium-term, further reductions in the size of the public sector might well be appropriate, and here additional efforts to overhaul the state enterprise sector would be welcome. I understand that there has already been a significant reduction in the work force in these enterprises, and welcome this. I also understand that there is to be another large financial package for the state enterprises, and I hope that this will be the last of such packages, as is indeed the stated intention.

Some issues have been raised concerning the medium-term strategy of fiscal consolidation. Specifically, the authorities anticipate a simultaneous reduction in the deficit and in the tax-to-GDP ratio. This strategy seems appropriate, since the tax burden is relatively high at 47 percent of GDP. However, the authorities should stand ready to tailor future planned tax rate reductions to developments on the expenditure side. And as income taxes currently seem to have an undesirable combination of high marginal tax rates and large exemptions, I would encourage the authorities to persist with, and possibly strengthen, their tax reform efforts in this area. It should be possible to achieve a significant improvement in incentives without losing tax revenue.

Still on the subject of structural reform, I welcome the new banking law and I hope that it will soon prove possible to increase competition within the banking system by gradually phasing out the existing stop-gap measure, which limits interest rate competition between the banks.

The most important ingredients for the successful management of the Austrian economy are already in place, and I am confident that the Austrian authorities will continue to take the appropriate policy actions. As the policies discussed above are implemented, the Austrian economy will acquire the flexibility needed to allow it to change from an economy relying on a number of traditional capital-intensive industries to one based on a broader range of industries consistent with the country's changing comparative advantage.

Finally, I support the proposal that the next Article IV consultation with Austria be held in 24 months.

Mr. Alhaimus made the following statement:

The Austrian economy has performed reasonably well in the recent past, especially in comparison with other small industrial countries' economies. This economic record has now encountered numerous strains--including slower growth, partly caused by sluggishness in the industrial sector and by the current account deficit projected for 1987. Such problems call for a broad-based policy response, especially in the areas of fiscal management and export promotion.

For quite some time, the social partnership and a hard currency policy have been the keys to Austria's domestic and external economic policies. Though they have generally served the economy well, they have also sometimes confronted policymakers with the need to evolve a critical balance between the competing imperatives of the two policies. Nevertheless, I endorse the authorities' intention to maintain this basic policy stance in the present and foreseeable circumstances.

The 30-year old social partnerhip involves all the productive agents in the economy, with the Government essentially playing a supportive role. The arrangement has helped to promote productivity, high employment, relative price stability, living standards, and, above all, peace and harmony in the labor market. Accordingly, despite the 5 percent increase in the average annual compensation per employee effected in 1986, in the face of an overall growth rate of less than 2 percent, Austria still improved its unit labor cost position. However, in the uncertain circumstances now emerging, the social partners will do well to respond positively to the Government's latest initiative by trying to maintain the effectiveness of the system and its gains despite the Government's reduced ability to provide new incentives and financial support. The need for caution is underscored by the apprehension caused by the present forecast of an increase of about 5 percent in compensation per man-hour in 1987, in the face of the projected increase of 4 percent in productivity and no increase in output, which may pose a threat to the competitiveness of Austrian exports and may also increase the rising rate of unemployment.

Over the years the authorities have used the hard currency policy to maintain the climate of domestic socioeconomic stability necessary for a viable social partnership. Although this hard currency policy should, as Mr. Schneider rightly indicated, not be interpreted too narrowly, constant surveillance is still required to keep economic policies broadly in line with trends in the German economy. Prolonged and wide divergences can disrupt Austria's foreign trade, and thereby adversely affect inter alia, growth, employment, and wages. Although the authorities now find themselves without an attractive alternative to the hard currency policy, efforts to broaden the list of trading partners and to address weaknesses in the current account are worth pursuing. The hard currency policy may also affect the gradual integration of EC economies, especially in the wake of the amendments to the Treaty introduced in the "Single European Act." I hope the staff can throw some light on the extent of the harmony that Austria must maintain with Germany's policies in order for the present benefits of the hard currency policy to continue in the future.

At the moment, the fiscal area is the biggest challenge posed by the success of the hard currency policy, as fiscal developments have over the years diverged a great deal from the trends in Germany's public finances. These divergences may seriously strain the social partnership, as well as the hard currency policy, and the proposed consolidation of public finances over the next five years is therefore welcome. The speedy structural adjustment of the nationalized industries will also be an imporant step in the right direction. However, I tend to share the staff's concern that the measures proposed in the 1987 budget appear insufficient, and also wonder why the authorities place relatively greater emphasis on expenditure restraint in their fiscal consolidation efforts.

Finally, I compliment the Austrian authorities on the increased percentage of GDP allowed for official foreign assistance in 1985, and encourage them to continue to expand their assistance program.

They may also take steps to reverse the downward trend in private capital flows to developing countries experienced in 1985. I wonder if the staff has by now received data for 1986 in this regard.

Mr. Sliper made the following statement:

Austria's economic performance has continued to be impressive over the last year; many Ministers of Finance and economic policy advisors would be very satisfied to boast of recent economic achievements like those in Austria. Steady growth, extremely low inflation, and balanced external accounts combine to place Austria in an enviable position. However, as Mr. Schneider noted, some problems are emerging, and these will present a real challenge to the authorities.

The most recent package of measures seems aimed in the right direction; and the reforms announced for the nationalized industries should mark a decisive step in getting these enterprises to operate more profitably and efficiently. However, these measures still left me with some feelings of reservation, partly because the elections have just been completed, providing a political opportunity for bold action. For example, the announced reform of the nationalized enterprises does represent clear progress. The transformation of the holding company, together with its new mandate to operate in a businesslike fashion, should allow restructuring to take place more quickly than in the past, when the political authorities were more involved in the decision-making process. Yet the announced government guarantees for the nationalized industries were disappointing: such guarantees are a most undesirable form of assistance, lacking transparency and removing many of the disciplines inherent in enterprise management, including the lender's responsibility to assess business viability vigorously. I hope that the Austrian authorities seek to phase out assistance to these nationalized industries, and indeed seek as a matter of priority to leave the guarantee business altogether.

The fiscal position and the proposed reduction in the budget deficit from 4.9 percent of GDP for 1987 to 2.5 percent of GDP by 1992 are also a little troubling. This reduction represents a very modest adjustment path which could easily go off course. In passing, I share the reservations expressed in the report prepared by the Vienna Institute of Advanced Studies concerning the scenario analysis of fiscal consolidation. Many macroeconomic models do ignore the very important confidence and expectation effects that are obviously present when a government commits itself to a bold fiscal reduction program. These effects can significantly alter past economic relationships, and thus models can often be of limited value in projecting future trends in such circumstances.

The staff's indication in its report that a significant increase in agricultural subsidies is contained in the 1987 budget is somewhat surprising, as such a proposal is totally inconsistent with the Government's intentions to generally cut back on enterprise assistance, and with the Government's efforts to curtail general government expenditure. It is also at odds with the growing commitment of all industrialized countries, including European countries, to cut back on agricultural assistance. I would welcome any staff comments as to the nature of the increase in the agricultural subsidies and the rationale for such a move.

It is good to see that Lord Keynes is still alive and well in Austria. The "contingency reserve" budget mechanism seems very much to reflect the fiscal stimulus or pump-priming approach to economic policymaking that he advocated many years ago. However, many of us can attest to the dangers of encouraging a government to engage in fiscal fine tuning, such as that indicated here. I join the staff and the authorities in their view that this contingency reserve should not be utilized, even if economic activity contracts more than is now projected.

The hard currency policy adopted by the authorities has led to a significant strengthening of the Austrian schilling over the last 12 months or so, both in real and nominal terms. Coupled with developments on the wage front, this raises some concerns about Austria's competitive position; although steady gains have been recorded in productivity, wage rates have been substantially above inflation in the last two years or so. Significant labor agreements also have been negotiated, reducing working hours.

The appreciating exchange rate and the wage developments foreshadow some potential problems concerning competitiveness. I would be interested to hear the views of the staff and Mr. Schneider on this matter.

The proposal to put Austria on a 24-month cycle on a bi-cycle basis is appropriate, given the very impressive economic management record of the Austrian authorities over recent times. However, it has been suggested that a 24-month bi-cycle may not necessarily be the most appropriate arrangement in all cases: while it likely represents a saving in Board time, it may have little effect on staff resources. It has also been suggested that there is greater scope for using an 18-month cycle, an issue that should be more generally discussed in the forthcoming review of the consultation procedures.

Mrs. Hepp made the following statement:

Austria seems to have reached the economic objectives of many countries: moderate but sustained growth, within stable internal and external conditions. During the last 14 years, real GDP growth averaged 2.3 percent and inflation 5.5 percent. In 1986, the rate of unemployment was only 5.2 percent, while the external current account surplus amounted to 0.2 percent of GDP. These results have been better than the average of all smaller industrial countries, and those of many other countries as well.

The hard currency policy, which closely links the Austrian schilling to the deutsche mark, and the so-called social partnership have been the fundamental economic policies on which these favorable developments have been based. There are however two areas--related to fiscal and monetary policy--that could pose a potential problem for the future evolution of Austria's economy.

Since 1983, Austria's general government deficit has been larger than Germany's, reaching an estimated 5.1 percent of GDP in 1986, compared with about 1 percent for Germany. The widening divergence of fiscal policies could weaken Austria's external position, and if not reversed, could erode the basis for the maintenance of the hard currency policy. The authorities are fully aware of the need to reduce the fiscal deficit, as the consolidation program shows; we encourage the authorities to persist in the fiscal consolidation program, even during the economic slowdown now expected for the present year. Should the slowdown materialize, we agree with the staff that additional possibilities to keep the budget on track should be explored.

We welcome the emphasis placed within monetary policy on the exchange rate, where the hard currency policy is also a condition for a stable monetary policy. But we are concerned about the banks' low profits performance, and the existing interest rate agreements between banks. The new banking law is important, but there is some room for further improvements in competitiveness, efficiency, and profits in the banking sector.

Austria has had a good economic performance over many years, which is a good reason to hold Article IV consultations on a two-year cycle. We therefore support the staff proposal.

Mr. Kyriazidis made the following statement:

The Austrian economy has for many years been managed carefully and successfully. The authorities have held clearly in mind the open nature of their relatively small economy, and have adapted the domestic economic structure flexibly to the changing external environment. The hard currency policy, which implied a major effort to coordinate domestic economic variables with those of neighboring countries, is a typical example of this flexibility. These commendable efforts have led to 2.5 percent annual growth on average in 1974-86--remarkable by European standards--in an environment of price stability and social consensus. Growth decelerated in 1986, while the unemployment rate rose significantly, and the fiscal deficit deteriorated. More positively, the external accounts remained balanced, and the inflation rate and unit labor costs converged with those of Germany. Both are essential in sustaining the useful hard currency policy.

The overall picture appears favorable, with two exceptions: the prospective further deceleration of growth and rise in unemployment in 1987; and the size of the fiscal deficit: I broadly agree with the staff appraisal with perhaps one exception: the emphasis placed on the fiscal deficit, and the priority given it by the staff even in the short run, at the expense of measures needed to tackle the rise in unemployment. I agree fully with Mr. Schneider that the rise in unemployment represents a most serious problem for the authorities, and I am disappointed that the staff does not focus enough on this issue. Although the recent rapid rise in the working population--to some extent underlying the increase in unemployment--will be reversed by 1993, the industrial restructuring policy of the authorities has also been an important factor, and a deeper analysis of both unemployment and of the authorities' plan to face it would have been welcome.

With regard to public expenditure, the staff's concern is perhaps a little exaggerated. While there was indeed a sizable increase in public expenditure in 1982-83, the level of expenditure compares favorably with that of other European countries; the fiscal deficit--after the jump in 1982-83--has been kept well under control ranging between 4.5 percent and 5.1 percent of GDP in 1984 and 1985. A persistent rising trend in the fiscal deficit would have been cause for serious concern, but that is not the case and the Austrian authorities have already taken measures to contain the deficit for 1987 below the level allowed in 1986. These measures are particularly courageous given a sluggish economy and rising unemployment, and as GDP growth is particularly sensitive to public expenditures in Austria.

We fully support the view that the divergence in the sizes of the fiscal deficits incurred respectively by Austria and Germany can create serious obstacles for the pursuit of the hard currency policy. This danger would however arise only if the divergences were allowed both to persist and to widen. We therefore endorse the authorities' medium-term consolidation plan as an essential precautionary measure against such a danger, but in the short run and especially in 1987, the staff's call for fiscal austerity seems inappropriate. The virtual balance in the current account, and a savings ratio higher than that of Germany, indicate that there is room for some public sector dissaving without the need for any further containment of domestic absorption. Furthermore, monetary policy seems appropriate to prevent any monetization of the fiscal deficit, which could indeed undermine confidence and lead to inflationary expectations.

In view of all these considerations, we do not share the staff's implicit view that fiscal policy in 1987 is insufficiently restrictive. We also endorse the authorities' policy on fiscal reform, which implies a decline in the budget revenue/GDP ratio by about 2 percentage points in the coming years, as we are less concerned than the staff about the effect of this fiscal austerity. In fact, the supply-side effects induced by the fiscal reform are likely to enhance the climate for gross investment expenditures--currently disappointingly sluggish and declining. These remarks do not imply disagreement with the basic principle of fiscal caution. Nor do they contain a call for anticyclical policies. They are prompted by the belief that in the economic conditions apparently developing in Austria, fiscal austerity might be too much of a good thing: it might well constitute a procyclical policy that would compound problems, particularly on the unemployment front. We thus fully endorse the authorities' intention to accept the expansion of the fiscal deficit if that occurs as a result of a possible decline of economic activity just as we endorse their intention not to trigger the emergency mechanism. Within this framework, the determined policies of restructuring state-controlled industries is an element essential for prudent consolidation and for enhanced prospects of modernization and growth in the Austrian economy.

Mr. Schneider, referring to the effect of the completion of the European Community's internal market on Austria-EC relations, states that "Austria's competitiveness can only be maintained if the same conditions for trade in goods and services that exist within the European Community also prevail between the Community and Austria." As far as I know, Austria has a free trade agreement with the European Community, which allows EC access for Austria's products, free of duties and quantitative restrictions. I wonder whether Mr. Schneider could elaborate somewhat further on this point, since his remark appears to indicate that the completion of the internal market might adversely affect Austria's position in relation to the European Community.

Mr. Salehkhou made the following statement:

Despite the sluggishness of the world economic situation and the slowdown in the economies of European countries, Austria's performance continued to be satisfactory and generally better than that of the other smaller industrial countries. Austria has built its economic strategy on two main pillars: a hard currency and the social partnership. This strategy has led to relative success in growth, inflation, and the external payments position. The authorities are to be commended for their efforts at a time when the world economic situation has not been very encouraging, and I broadly agree with the staff appraisal.

Austria must maintain a hard currency policy, despite the prevailing differences with neighboring Germany underlined by the staff. This policy has indeed allowed the authorities to stabilize exchange rate movements with respect to their main economic partners, and to achieve their monetary and some fiscal objectives in an orderly manner.

The exchange rate has been stabilized by maintaining the value of the schilling to the deutsche mark at $7.03 = DM1.0, notwithstanding the recent appreciation of the deutsche mark.

The external current account improved somewhat in 1986: after a small deficit in 1985, savings on oil imports helped to create a surplus of about 0.2 percent of GDP, despite the adverse international economic environment characterized by erratic fluctuations in exchange rates and insufficient growth in export markets outside Europe.

Although exports to Western Europe, and in particular to Germany, have increased--thanks to improved industrial competitiveness--there has been an overall decline in exports. That decline was however offset by a 5 1/2 percent reduction in imports.

Austria's hard currency policy also contributed to the satisfactory results of monetary policy. Net outflows decreased, reflecting both higher transfers by Austrians residing abroad and higher placements in schillings by foreigners. The hard currency policy allowed the authorities to keep the inflation rate lower than in Western European countries other than Germany and Switzerland.

The implementation of tight fiscal measures was complicated by major social and political considerations, and the continuation of the budget consolidation process proved difficult. While the federal budget deficit was reduced to 4.4 percent of GDP in 1985, as compared with 5.5 percent in 1983, there was no further progress in 1986, when the deficit increased to more than 5 percent. I therefore welcome the authorities' stated intention to gradually reduce the deficit to 2.5 percent of GDP by 1992, although I tend to agree with the staff that the objective of 4.9 percent of GDP in 1987 casts some doubt on the feasibility of the projected budgetary consolidation.

The Austrian authorities should be commended for their social partnership strategy, which has permitted the maintenance of a good social climate for thirty years. This strategy produced effective and satisfactory results with respect to employment, relative price stability, real GDP growth, and labor relations, leading to improved productivity and living standards. To maintain this situation, the social partners are discussing proposals to reduce the fiscal deficit, which include in particular plans to lower expenditures and strengthen the buoyancy of the tax system. The Austrian authorities are determined to narrow the large divergence in fiscal performance between Austria and Germany, following their acceptance of the need for a closer alignment of exchange rates and monetary policies between the two countries. For GNP growth to be sustained, Austria must reduce the general government deficit and domestic absorption. Thus, wage, salary, and pension increases, as well as transfers to the social security system, must all be contained, and subsidies to the public and private enterprises cut. The projected tax reform should also introduce a simpler and fairer system, while stabilizing the current very high level of taxation.

As Mr. Schneider explained, the social partners will have to suffer new constraints under these tight fiscal measures. In trade policy, despite expressed concerns about current protectionist tendencies which are seriously affecting the expansion of international trade, the Austrian authorities maintain major trade restrictions to protect their textile and clothing industries. These restrictions especially affect exports from developing countries.

There was an improvement in Austria's official development assistance in 1985. Although close to the average maintained by other members of the Development Assistance Committee at 0.38 percent of GDP, it is far below the UN target of 0.7 percent. Austria's comfortable external position gives room for hope that the authorities will soon revise this figure in the right direction.

Mr. Rousset made the following statement:

The overall economic situation of Austria remains generally satisfactory. However, the moderate downswing in economic activity following a slight worsening of labor market conditions is rather disappointing. Nevertheless, domestic demand's delayed response to the noticeable terms of trade gains experienced in 1986 should not have a lasting impact on the medium-term growth prospects of the economy. The external position was still sound last year, and no compelling reasons appear for questioning the hard currency strategy. The staff and Mr. Schneider are however right to stress that the sustainability of such a policy option will hinge on the continuing convergence of the Austrian and German economic performances. The fiscal consolidation scheme, announced at the beginning of this year, clearly indicates the authorities' lasting commitment to their stable exchange rate policy. Apart from this main consideration, the willingness to cut the central government deficit seems all the more warranted, as public debt is growing steadily and is now approaching 50 percent of GDP.

The medium-term program is certainly ambitious, as a tax reduction is planned along with the curtailment of expenditures. Together these imply expenditure restraint amounting to 4.5 percent of GDP, in order to produce a 2.5 percent reduction in the federal deficit. At least two elements should be considered by the authorities, so far as the mix between expenditure and revenue measures is concerned. The federal tax burden, standing at 27 percent of GDP, could appear heavy: the overall ratio of tax revenue to GDP nonetheless compares favorably with that of other countries, especially in Europe. The stabilization of tax pressure at the present level should therefore not undermine the consolidation process, and as the income elasticity of fiscal revenue appears to be rather low, an interesting way to stabilize the tax ratio would be to enhance revenue buoyancy; value-added tax proceeds, now one third of total revenue, could be increased. I would be interested to hear any comments from Mr. Schneider or the staff on the advisability of such an approach.

I support the proposal that Austria be placed on a 24-month cycle for the next Article IV consultation. The current prospects for the economy and the basically sound policy conducted by the authorities amply justify this change in present practices.

Mr. Posthumus made the following statement:

I agree with the staff appraisal of Austria's financial and economic policies, and I support the aims of exchange rate policy. That is unsurprising, as my country follows a similar approach. However, a policy directed at stable exchange rates requires a flexible monetary policy, including interest rate policy; also required are overall internal policies that make stability sustainable. I agree with the staff that sustaining the hard currency policy by an over-reliance on high interest rates could result in damage to growth, but I agree only because the appraisal says "too much reliance on high interest rates." Interest rate policy must certainly be flexible while it is aimed at a stable exchange rate.

Like Mr. Grosche, I wonder whether it is fiscally prudent to lower income tax rates while the deficit is larger than seems sustainable. The reduction in income taxes was intended to compensate for fiscal drag; but the reduction was not brought about by means of changing marginal tax incidence, so despite the claim to compensate for fiscal drag, that was not the real effect. A reduction of taxes would certainly strengthen the general feeling that there is not much of a relationship between budget expenditures and budget revenues--a tax policy should of course take that relationship into account.

Public expenditure has a very high share of GDP in Austria, certainly compared to that encountered in a number of other small countries, and a decrease in expenditure should perhaps not be the only instrument available to reduce the budget deficit. Like Mr. Sliper, I felt a bit concerned about Mr. Schneider's remark on the contingency budget; further clarification might be useful, while the Austrian Government's decision not to use the budgetary contingency is certainly welcome.

For a number of years, Austria has sought some foreign financing of the budget deficit. As a capital market with sufficient savings is available domestically, foreign financing of the deficit only weakens fiscal discipline: foreign financing makes it easier to finance the deficit and therefore more difficult to control it. This latter effect is feared by my authorities in the Netherlands. Finally, I would suggest that as in earlier cases, we decide whether to put Austria on a 24-month cycle only when we have a general debate on this subject.

Mr. Hospedales stated that he was in broad agreement with the thrust of the staff's well-balanced and technical appraisal outlining the impressive economic management and favorable evolution of the Austrian economy. The one area of vulnerability that could possibly impair medium-term growth and employment prospects--the persistently high federal deficit--was now subject to policy action. The mediumterm fiscal consolidation approach of the new Austrian authorities, underlined by Mr. Schneider, was broadly appropriate and well founded, especially given available savings and the need to avoid adverse and negative effects on domestic economic activity. Its sustained implementation would certainly ensure the satisfactory performance of the Austrian economy over the medium term.

His chair wished to associate itself with the remarks of the staff and other Directors complimenting Austria for its official development assistance, which was above the average of the member countries of the Development Assistance Committee and rose by ten basis points in 1985, as a proportion of GNP, Mr. Hospedales concluded. That was a good approach to international economic cooperation; he hoped that the envisaged medium-term fiscal consolidation process would not impair Austria's ODA performance in future years, and that every effort would be made to continue its improvement.

Mr. Lundstrom made the following statement:

I broadly share the staff's positive assessment of recent Austrian economic policy.

As underlined by Mr. Schneider, the Austrian economy is highly dependent on external factors. Recent economic developments in Austria can however certainly be largely attributed to successful economic policies. It is nonetheless disappointing that real growth last year was not sufficient to protect unemployment from increasing further, and that export performance turned out poorly.

I would like to touch upon some special features of the Austrian economy, in particular the hard currency policy, the nationalized industries, and the incomes policy of social partnership.

If fundamental economic conditions in Austria do not develop in concert with those in Germany, the result will be strong pressure on interest rates. In the case of slower economic growth, considerably higher interest rates--higher than desirable with regard to domestic demand components--might be required. In trying to avoid this outcome, the authorities will have to rely primarily on fiscal policy measures.

Nationalized industries place a heavy burden on public finances, and might even contribute to structural unemployment by hampering cost effectiveness. Therefore, like the staff, I welcome the steps being taken to improve the financial position of these industries, and I hope that the multiyear assistance package will contribute to improved efficiency. I especially note the support earmarked for technical innovations, as the need for a more diversified industrial sector seems to be underlined by the recent disappointing development in exports and by the decline in industrial production. The combination of a policy that ties the Austrian schilling to the deutsche mark, and a heavy reliance on the production of basic and semifinished goods, seems to lead to an undesirably high vulnerability.

The social partnership has been instrumental in restraining cost pressures: the hard currency policy necessitates moderate wage developments, which it has been possible to achieve by offering various social "rewards," the most important being government support to maintain employment. The prospect of slower growth, coupled with the need to limit subsidies, complicates the situation. It would be interesting to hear any comments--by Mr. Schneider or the staff--about the results of the discussions that commenced in March of this year between the social partners.

The hard currency policy, the industrial policy, and the incomes policy place a heavy burden on fiscal policy. The consolidation program of the new Government is said to include measures directed toward a turnaround of government debt as a percentage of GNP after 1992. Indeed, the major policy challenge facing the Austrian authorities now lies in consolidating federal government finances without compromising the achievements made in other policy areas. However, given the present growth prospects for the Austrian economy, there is a great risk that the budgetary outlook will also deteriorate, while increased external borrowing cannot be regarded as a realistic alternative to fiscal consolidation. Therefore, like the staff, I cannot fully support the authorities' determination to concentrate on cutting expenditures to this end. I agree with Mr. Grosche and Mr. Posthumus that it currently seems inadvisable to allow the gains from the tax reform to be transformed into lower income tax rates. Compared to those of many countries, income taxes in Austria are relatively modest. Marginal tax rates on average wages are lower than those of the Netherlands, Belgium, and the Nordic countries--except Finland--and also Germany and Italy.

In sum, positive factors still dominate the Austrian economy. However, the worrying signs point in the same direction: if credibility and confidence are to be maintained by the hard currency policy, there is no room for slippages in the implementation of fiscal policy.

Finally, Austria would seem to be well suited to a bicyclic arrangement, a procedure that is less demanding than the 18-month cycle, even in terms of staff resources; but we shall soon have an occasion to discuss this question more fully.

Mr. Santos made the following statement:

For a number of years Austria's economic performance has been remarkable. The growth of GNP has been stronger than in other smaller industrial countries, while inflation has remained very low and in line with that of its major trading partners. Moreover, the rate of unemployment, although rising, has been one of the lowest in Europe, and the external account position has been satisfactory. These favorable developments continued in 1986, albeit at lower rates. While the authorities should be commended for these positive developments, a number of economic and financial indicators point to potential problems that need to be addressed, if the gains achieved so far are to be safeguarded.

The ratio of the budget deficit to GDP, which was relatively low, has increased from 2.6 percent in 1981 to 5.5 percent in 1986. This unfavorable development is largely attributable to the transfers to state enterprises. Unless steps are taken to contain the growth of the deficit, this increase could put a great deal of pressure on the external position, particularly because of the divergence in financial policies between Austria and its major trading partner, Germany. Considering the likely effect of a growing deficit on monetary and credit policy, this could also make strict adherence to the hard currency policy very difficult. I therefore support the medium-term consolidation of the public sector, and in particular, the restructuring of the public enterprises and the reform of the pension insurance system. However, I wonder whether the pace of the planned budget deficit reduction should be accelerated in light of Germany's cautious demand-management policy, even though the high interest payments and the statutory constraints on some expenditure items allow little room for maneuver. Thus, I welcome the social partners' support for the coming adjustment, as the social partnership strategy, with its emphasis on wage moderation and the avoidance of labor-management conflicts, has substantially aided the performance achieved so far by containing the cost of production and encouraging employment creation.

The hard currency policy has had a favorable impact on price stability in Austria since Germany accounts for at least 41 percent of imports and 30 percent of exports, I encourage the authorities to continue to pursue this policy, as it creates a stable environment conducive to investment and long-term planning. It is, however, possible that more flexibility should be introduced in the foreign exchange policy at a time when the restructuring of the industrial sector is being contemplated, with a view to making the latter more competitive.

Finally, the Austrian authorities deserve our appreciation for their policy stance on official development assistance. It is highly encouraging that Austria increased the level of assistance to developing countries in 1985, despite the increasing need to contain expenditure. We encourage the authorities to pursue this policy in the future.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/87/75 (5/15/87) and EBM/87/76 (5/20/87).

3. CHILE - EXTENDED ARRANGEMENT - MODIFICATION OF PERFORMANCE CRITERIA

1. The letter dated May 11, 1987 from the President of the Central Bank and the Minister of Finance of Chile shall be attached to the extended arrangement for Chile, and the letters dated July 9, 1985, January 20, 1986, June 18, 1986, and December 15, 1986 together with the respective annexed Memoranda on the Economic Policies of Chile, shall be read as supplemented and modified by the letter dated May 11, 1987. Accordingly, the ceilings referred to in paragraph 3(b) of Decision No. 8512-(87/21), adopted February 4, 1987, shall be modified as proposed in paragraph 6 of the letter dated May 11, 1987.

2. The Fund finds that satisfactory arrangements have been made for financing Chile's balance of payments in 1987. (EBS/87/102, 5/12/87)

Decision No. 8595-(87/76), adopted May 19, 1987

4. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of an Assistant to Executive Director as set forth in EBAP/87/109 (5/14/87) and EBAP/87/109, Correction 1 (5/15/87).

Adopted May 18, 1987

5. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 86/149 through 86/151 are approved. (EBD/87/128, 5/12/87)

Adopted May 18, 1987

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/87/110 (5/14/87) and EBAP/87/112 (5/18/87), and by Advisors to Executive Directors as set forth in EBAP/87/110 (5/14/87) and EBAP/87/111 (5/15/87) is approved.

APPROVED: December 1, 1987

LEO VAN HOUTVEN
Secretary