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0404

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 87/77

3:00 p.m., May 20, 1987

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	W. K. Parmena, Temporary
	Wang X., Temporary
	D. C. Templeman, Temporary
J. de Groote	H. G. Schneider
	M. Hepp, Temporary
	T. Alhaimus
G. Grosche	
	Hon C.-W., Temporary
	J. Hospedales
	D. A. Woodward, Temporary
H. Lundstrom	
	D. McCormack
	K. Yao, Temporary
	L. P. Ebrill, Temporary
	L. Filardo
	V. Rousset, Temporary
G. A. Posthumus	
	I. Sliper, Temporary
G. Salehkhou	
	A. Vasudevan, Temporary
	T. Morita, Temporary
	N. Kyriazidis

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

Also Present

Asian Department: H. Neiss, Deputy Director. European Department: M. Guitián, Deputy Director; J. Hauvonen, L. J. Lipschitz, J. T. Reitmaier, H. Ungerer. Exchange and Trade Relations Department: J. T. Boorman, Deputy Director; P. Fontana. Legal Department: J. M. Ogoola. Advisor to Executive Director: P. Péterfalvy. Assistants to Executive Director: S. M. Bethel, F. Di Mauro, M. A. Hammoudi, K.-H. Kleine, M. A. Kyhlberg, G. Schurr.

1. AUSTRIA - 1987 ARTICLE IV CONSULTATION

The Executive Directors resumed from the previous meeting (EBM/87/76, 5/20/87) their consideration of 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).

The staff representative from the European Department said that discussions between the social partners had begun in March, and were expected to continue for some time. The talks would likely include discussions of the effects of wage moderation on employment prospects, the need for more precise targeting of relief measures for unemployment, and also perhaps the flexible implementation of early retirement arrangements.

The staff did not advocate an increase in Austria's external balance of payments surplus, the staff representative continued. The remark on page 7 of the staff report had been directed toward the need to reduce domestic absorption, mainly with regard to the budget deficit and with the aim of safeguarding the external position, but not necessarily to improve the current account to any great extent. The staff certainly favored domestic investment, because private investment would in the longer term enhance employment and competitiveness, and by doing so would of course also improve the external position in line with the requirements of the hard currency policy.

The staff joined some Directors in supporting special measures to alleviate unemployment, the staff representative noted; while other speakers had observed that the reduction of unemployment should be given a higher priority in fiscal policy for 1987, the increasingly self-perpetuating character of the budget deficits mandated fiscal consolidation as soon as possible. Furthermore, the authorities agreed with the staff that unemployment was mainly structural; past expansionary fiscal policies might even have contributed to unemployment by preserving inefficient or less efficient production within the economy, and by increasing the share of transfer payments within public expenditure. Demand stimulation at that point would only postpone a solution to the unemployment problem.

The hard currency policy had generally been supported by Directors, the staff representative observed, but there had also been some concern with regard to competitiveness, a concern to some extent shared by the staff and the authorities. There was however no reason for any immediate worry; the Austrian authorities placed particular emphasis on a policy which maintained confidence, and considered the benefits of such a policy to be greater than the cost of a limited and perhaps temporary loss in the area of competitiveness.

The hard currency policy would also be helpful in aligning the economy with the European Community, the staff representative continued, particularly in view of the close relations that existed between Austria and Germany and also between Austria and other countries in the EC. The necessary preconditions would however have to be met consistently if a hard currency policy was to be pursued; in addition, the policy had always been seen, with some justification, as a tool of discipline by the Austrian authorities, as it would encourage, if not force, industry to become more competitive. The Austrian authorities would after all face a major challenge--to become more internationally competitive--if they wished to align the economy more closely with the EC.

Given the substantial difficulties involved in budget consolidation, it was somewhat disappointing that more progress could not be made in 1987, the staff representative said. Of course, the staff did recognize that there were limitations, mainly due to the legal commitment of major expenditure categories, and the staff thus found it encouraging that the Government had nevertheless found ways to trim expenditures.

Tax reform was a complex subject, the staff representative considered. A key question was whether all the gains that would come from the abolition of exemptions should be used to lower tax rates. Limited tax cuts would indeed tend to increase work incentives; but there was no need for further incentives to save, because Austrians already performed very well in that respect. In general the staff favored tax reductions, as tax rates were quite high in Austria, but not at any price. Fiscal consolidation would have to take priority over tax reductions, because it underpinned the hard currency policy, and because it was very important for the productivity of the economy. Austria had had a problem of competitiveness, and the economy would therefore have to be internationalized, and new markets gained.

The relatively substantial share of public expenditures in GDP pertained both to the Federal Government and the General Government, and Table 13 of the background paper showed that the share of the latter in GDP amounted to nearly 50 percent, the staff representative noted. That was by no means a low share, and the staff thus endorsed in principle the authorities' view that consolidation should concentrate on the expenditure side.

In 1985, the pension reform had been achieved mainly by raising contributions, the staff representative remarked. For 1989, no details were yet known, but as there was a certain commitment not to increase contributions, benefits would apparently be streamlined and targeted better, and the overlapping of various benefits schemes avoided.

The Government had sought foreign financing for various reasons, the staff representative continued. Those included interest rate considerations; the narrowness of the domestic capital market; the question of the mix of maturities with regard to public debt; the desirability of a continued presence in foreign markets; and considerations concerning the level of international reserves. The staff had no evidence that foreign borrowing encouraged deficits: budget deficits in Austria were more demand-induced than supply-induced--in the sense that there was simply a large demand for all sorts of public services.

Agricultural subsidies had increased in 1987 as a result of the existing price and market regulations in Austria, with regard to which the Government had certain commitments, both generally, and, for example, in handling the crisis in the wine sector, the staff representative explained. The Government intended to stabilize expenditure on agriculture by changing market regulations to generate a higher share of contributions from the agricultural sector itself. The recent decline in agricultural self-employment had in addition exacerbated unemployment problems, particularly in regions that had also suffered from other structural problems, mainly in the eastern part of Austria--an aspect of agricultural support that should not be completely overlooked.

Additional support for the nationalized industries had become necessary for several reasons, the staff representative said. There was a general world-wide weakness in demand for the products of the nationalized industries; economic difficulties in certain countries--mainly in eastern Europe and in OPEC countries, which traditionally had been the main customers for those products; and the appreciation of the schilling. Additional support was necessary if those industries were to continue their restructuring efforts, although the right amount of assistance could be the subject of discussion.

Government guarantees were clearly the best mechanism by which the authorities could continue with the restructuring effort, because the companies facing a difficult financial situation would otherwise not be able to borrow on the market, the staff representative from the European Department concluded. To avoid complacency, the management structure of the holding company and the individual companies had been changed, emphasizing the business aspect, and striking out any reference to macroeconomic considerations in the respective law. The authorities hoped that the new management structure would be helpful, and had in fact adopted a two-pronged approach to the problem: they had promised some more support, and at the same time had pressured companies to become more efficient and to act more like true economic agents. The authorities certainly intended to consolidate the situation, and to avoid the continued drain from weak nationalized industries on the budget in particular and the economy in general. They therefore hoped that the subsidies agreed for 1987 would indeed be the last aid package.

Mr. Schneider noted that the two major issues taken up by all Executive Directors had been the Austrian hard currency policy, and Austria's fiscal performance in comparison to that of Germany. Directors had rightly emphasized that in the longer run, the hard currency policy could be successfully maintained only if the fundamentals in both countries were more or less in harmony; as everybody was aware, the present Austrian fiscal situation was the weak spot in that picture and had to be corrected. Consequently, the coalition Government had adopted a medium-term approach to fiscal consolidation. In that context, he assured Mr. Sliper that the post-Keynesian period had arrived even in Austria, as demonstrated by the budget for 1987, which despite the low growth rate forecast for that year, contained no expansionary elements at all. Most

Directors had agreed with the authorities' medium-term approach to fiscal consolidation, he noted, and stressed that drastic cuts in major expenditure categories could not just be put into effect by governmental decree. Apart from the potentially harmful effects on growth and employment, such cuts would run counter to the social partnership strategy which had worked successfully for some decades. Thorough discussions were taking place to reach the necessary consensus, and following some convincing persuasion by the Government, the needed constraints would probably be accepted by the different groups involved. A discussion on a "zero wage round" was in progress, but it remained to be seen whether a zero average wage increase would be feasible. To demonstrate the determination of the authorities, and their awareness of the urgent need for fiscal retrenchment, the Minister of Finance had recently issued guidelines for the 1988 budget according to which each ministry would cut proposed total expenditures for 1988 by 8 percent, compared with 1987. The proposals were to be submitted to the Ministry of Finance by May 22, to allow sufficient time for any required legal changes. The authorities wanted to ensure that the goal of reducing the deficit for 1988 to 4.4 percent of GDP would be achieved, but that would not be an easy task, implying at best no real increases in incomes for a large part of the population.

His authorities shared the concern regarding the recent rapid increase in the federal debt, Mr. Schneider continued, and they were particularly concerned about the increasing ratio of interest payments to federal tax revenues--projected at more than 22 percent in 1987--which increasingly limited the authorities' already cramped room for maneuver. The authorities were therefore determined to arrest that increase over time, although that would be much easier to do if a higher real growth rate could be achieved.

His authorities shared the frustration of repeated financing packages for the nationalized industries, Mr. Schneider noted. But considering the worldwide decline of the steel sector and other basic industries, the new managements would be hard pressed to restructure the industry fast enough in response. The new financing package--S 33 billion guaranteed by the Government, S 8 billion derived from privatization, and a further S 8 billion allowed for innovations--would it was hoped allow the final completion of this needed restructuring. In the Austrian context, even a partial privatization of nationalized industries signaled an important change in the attitude of the Socialist Party. After World War II, in 1946 and 1947, heavy industries, the electric power industry, and the three largest banks of that time had been nationalized to avoid a takeover of those companies by the Russian occupation forces. The nationalization laws had been supported by both large parties at that time, parties that now formed the coalition Government. Many Austrians considered those nationalized industries to be public property that indirectly belonged to them. It was therefore not surprising that certain segments of Austrian society were rather reluctant to accept the notion of privatization and foreign ownership, because the people could not forget that foreign-owned plants in Austria had been closed down rapidly during the economic crisis in the early 1930s.

The coalition Government's goal was to stabilize the amount of agricultural subsidies disbursed during the present legislative period by limiting surplus production, Mr. Schneider said. Some subsidies were provided automatically as a result of legal procedures, which led to higher subsidies, because the better the harvest the more output had to exported at depressed world market prices. And the high unemployment rate made a switch of workers from the agricultural sector to other sectors both increasingly difficult and perhaps less desirable, as work in the fields and forests made an important contribution to protecting the environment. Austrians were certainly not the only sinners in the area of agricultural subsidies, but he had no information as to Austria's position on agriculture within the next GATT round.

The monetary authorities had tolerated the existing agreement between banks to limit interest competition and to secure adequate profit margins, Mr. Schneider commented, in order to allow a smoother transition to the main goal of the new banking law: an adequate increase in the capital base of the banks in relation to total assets. The confidence of the general public in the solvency of the banking sector could also be jeopardized if one of the banks had trouble; Austrians still remembered that one generation had lost its savings twice, after the two World Wars.

Austria's relationship to the EC ensured that competitiveness had to be maintained within the existing free trade agreement, Mr. Schneider stated. The Austrian institutional framework would have to be adjusted in many sectors, moving it as close to EC norms as possible, so as to keep pace with changes in the EC until 1992.

The Acting Chairman made the following summing up:

Directors commended the recent performance of the Austrian economy and pointed in particular to the high degree of price stability and the balanced external current account. Growth had continued in 1986, although at a slower rate than in 1985. The rate of unemployment, while remaining below that of most other industrial countries, was however rising, and short-term prospects for growth and employment were not seen to be favorable. Directors hoped that the social partnership, which had served Austria well in the past, would remain effective despite the announced shift in fiscal policy. Directors welcomed improvements in the structure of production and industrial exports, but felt that a faster pace of adjustment would benefit medium-term growth and employment prospects.

Directors endorsed the authorities' hard currency policy, focusing their specific comments on the implications of the close link being maintained between the schilling and the deutsche mark. Austria's competitiveness vis-à-vis Germany appeared to have been maintained during 1986, but some Directors thought that Austria's satisfactory external position might come under some strain from the effective appreciation of the schilling as a result of this link. Continued adherence to this exchange rate policy would therefore require domestic demand and cost restraint. Monetary policy had been geared toward the objectives of the exchange rate policy, and in doing so, had been conducted flexibly and efficiently.

Directors generally welcomed the announcement of a medium-term budget consolidation target to be achieved mainly through expenditure restraint. A gradual reduction in the federal budget deficit along the envisaged path was considered appropriate in view of both the authorities' exchange rate objective and the past accumulation of government debt. A number of Directors noted that the budget for 1987, while permitting only a modest growth of expenditure, did not represent a significant step in terms of the deficit reduction goal. Some Directors cautioned against any attempt at fine-tuning with fiscal policy. Many Directors encouraged the authorities to reduce current transfers and subsidies, and in that context, concern was expressed regarding the continuation of subsidies to nationalized enterprises and the proposed increase in agricultural subsidies. A number of Directors considered that it was perhaps not appropriate to plan for a significant reduction in the ratio of budget revenue to GDP as long as the overall fiscal deficit appeared unsustainable, as suggested by the continuing rise in the public debt to GNP ratio. At the same time, several Directors advocated tax reform, and saw room to increase the buoyancy of the tax system. However, not all speakers shared the perceived need for fiscal consolidation, in the context of the near-term economic outlook. Thus some Directors voiced doubts as to whether fiscal retrenchment and the restructuring of nationalized industries would lead to an offsetting near-term increase in private productive activity.

A number of Directors addressed the inefficiency and slow adaptation of the nationalized industries, which in their view had proved detrimental to the vitality of Austrian industry and a burden on the budget. They considered that the restructuring and selective privatization of publicly owned enterprises should be speeded up, so as to reduce significantly the need for government transfers.

Several Directors welcomed the new banking law and the improvement in the banks' equity position which had already taken place. In this context, some questioned whether the extension of the agreement limiting competition among banks would contribute to a more efficient banking system.

Directors urged Austria to continue its liberal trade policies and to further strengthen its record of official development assistance, which had been warmly welcomed and praised by a number of Directors.

It is expected that the next Article IV consultation with Austria will take place within 24 months, with an intermediate staff visit after which a brief report would be circulated to Directors. However, a final decision on the timing of the next Article IV consultation will be made after the Board's general discussion on the timing procedures for Article IV consultations.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/87/76 (5/20/87) and EBM/87/77 (5/20/87).

2. ARGENTINA - TECHNICAL ASSISTANCE

In response to a request from the Argentine authorities for technical assistance to review the current system of budget estimates and accounts, the Executive Board approves the proposal set forth in EBD/87/133 (5/14/87).

Adopted May 20, 1987

3. PEOPLE'S REPUBLIC OF MOZAMBIQUE - RELEASE OF INFORMATION

The Executive Board approves the proposal to release the background paper on recent economic developments in the People's Republic of Mozambique (SM/86/268, 11/4/86) to participants in the informal donors' meeting to be held in Paris on July 9-10, 1987, as set forth in EBD/87/136 (5/18/87).

Adopted May 20, 1987

APPROVED: December 1, 1987

LEO VAN HOUTVEN
Secretary