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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 87/121

3:00 p.m., August 7, 1987

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	E. T. El Kogali
Dai Q.	
C. H. Dallara	D. C. Templeman, Temporary
	J. Prader
	E. C. Demaestri, Temporary
M. Finaish	A. M. Othman
G. Grosche	
J. E. Ismael	
A. Kafka	J. Hospedales
	M. Foot
	R. Comotto, Temporary
J. Ovi	M. Fogelholm
M. Massé	D. McCormack
Mawakani Samba	
Y. A. Nimatallah	I. A. Al-Assaf
G. Ortiz	L. Filardo
H. Ploix	G. Pineau, Temporary
G. A. Posthumus	G. P. J. Hogeweg
	C.-Y. Lim
	S. Rouai, Temporary
	B. Tamami, Temporary
A. K. Sengupta	L. E. N. Fernando
K. Yamazaki	M. Sugita
S. Zecchini	R. Manfredi Selvaggi, Temporary

L. Van Houtven, Secretary and Counsellor
S. L. Yeager, Assistant

Also Present

IBRD: R. Nooter, Eastern Africa Department. Administration Department: G. F. Rea, Director; H. J. O. Struckmeyer, Deputy Director, J. B. Kaiser, G. Vaughan, H. Wiesner. African Department: A. D. Ouattara, Counsellor and Director; N. Abu-zobaa. European Department: M. Russo, Director; M. Guitián, Deputy Director; D. Gottlieb, M. Z. Khan, S. Mitra, H. O. Schmitt. Exchange and Trade Relations Department: J. T. Boorman, Deputy Director; S. Kanesa-Thasan, J. M. T. Paljarvi. External Relations Department: C. S. Gardner, Deputy Director. Legal Department: W. E. Holder, Deputy General Counsel; J. M. Ogoola, J. S. Powers. Middle Eastern Department: P. Chabrier, Deputy Director; M. A. El-Erian, P. H. Mathieu, M. Yaqub. Secretary's Department: J. W. Lang, Jr., Deputy Secretary. Treasurer's Department: F. G. Laske, Treasurer; T. Leddy, Deputy Treasurer; J. E. Blalock, P. J. Bradley, J. C. Corr, D. Gupta, D. V. Pritchett. Advisors to Executive Directors: M. B. Chatah, G. D. Hodgson, A. Ouanes, A. Vasudevan. Assistants to Executive Directors: A. R. Al-Abdullatif, F. E. R. Alfiler, J. R. N. Almeida, W. N. Engert, S. Guribye, M. A. Hammoudi, G. K. Hodges, A. Iljas, J. M. Jones, K.-H. Kleine, M. A. Kyhlberg, T. Morita, D. V. Nhien, D. Saha, H. van der Burg.

1. SWEDEN - 1987 ARTICLE CONSULTATION

The Executive Directors considered the staff report for the 1987 Article IV consultation with Sweden (SM/87/169, 7/16/87). They also had before them a background paper on recent economic developments in Sweden (SM/87/177, 7/24/87).

Mr. Ovi made the following statement:

> The Swedish authorities are in broad agreement with the contents of the staff report and its analysis of the problems facing the Swedish economy. The report gives a fair description of the main elements of the economic policy strategy pursued by the present Government since it took office in 1982. The authorities also believe that the report gives a balanced assessment of the achievements of these policies over the last five years. The turnaround in the Swedish economy has indeed been substantial. During this time, the gross national product has grown by an annual average rate of more that 2 1/2 percent. Profitability has recovered strongly and industrial investments have expanded; support to ailing industries has been virtually eliminated; and the deficits on the budget and on the current account have been substantially reduced. The unemployment rate has now fallen below 2 percent, while inflation has been substantially reduced and is running at a rate of 3-4 percent.
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> Since 1982, credit policy regulations have either been relaxed or abolished, and the deregulation is now essentially complete. In the field of foreign exchange control, the liberalization program that the authorities presented in 1986 is under way.
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> Like the staff, the authorities are convinced that, in order to consolidate and enhance their achievements, economic policy will have to remain firm and consistent. This will require additional efforts to constrain price and wage increases and a further reduction in the budget deficit.
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> Mainly as a consequence of falling oil prices, the weakening U.S. dollar rate, and the lower interest rate levels, the current account swung from a deficit of SKr 10.5 billion in 1985 to a surplus of SKr 6 billion in 1986. during the first six months of 1987 the trade balance showed a surplus of about SKr 15 billion--approximately SKr 5 billion lower than during the corresponding period last year. However, the outcome so far is well in line with the forecast in the Revised Finance Bill for the year as a whole, namely, a surplus in the trade balance of just over SKr 28 billion and a corresponding surplus in the current account of approximately SKr 1 billion.

During the first half of this year consumer prices rose by a mere 1.6 percent, partly as a consequence of the price freeze that was introduced on January 28. This price freeze is now being gradually dismantled. Still, it seems likely that the Revised Finance Bill forecast of a rise of 4 percent in the price level during 1987 will be realized.

Following a declining trend during 1986 and the beginning of this year, capacity utilization in manufacturing industries returned to a high level in the second quarter. Close to half the companies reported operating at full capacity.

Unemployment continued to fall during the first six months of 1987. The unemployment rate is now 1.7 percent, according to the new definition, which is identical to the International Labor Organization's definition.

Owing to a turnaround in market expectations, interest rates, both short- and long-term, rose considerably during the latter part of 1986 to a peak in late March 1987 of 11 percent for six-month rates and 12.1 percent for five-year rates. the Riksbank slowed the rise but did not resist the trend. Since then, the Riksbank has supported a fall in interest rates in the short end of the market, where rates have fallen to 9-9.5 percent. Long-term interest rates have been left to adjust themselves, with five-year rates falling to 11.2-11.7 percent.

Currency flows responded to the interest rate developments and turned from an outflow in preceding months to a heavy inflow of SKr 16 billion in February-April. Since then a small outflow has been registered.

The budget deficit has continued to improve since fiscal year 1982/83 when the deficit was SKr 87 billion, equivalent to 13 percent of GDP. For fiscal year 1986/87 the deficit is now estimated at approximately SKr 20 billion, equal to some 2 percent of GDP, or about half the original forecast. At present it seems likely that the deficit for fiscal year 1987/88 will also be lower than the forecast in the Revised Finance Bill of SKr 30 billion.

With regard to economic policies, the Swedish Government and the staff are again in broad agreement. A restrictive fiscal and monetary policy stance will have to be continued. In particular, budget policy will remain restrictive in order to combat inflation and to hold down the increase in private consumption. Also, to maintain a sufficiently high growth rate in the medium and the longer term, various measures to improve the performance of the economy, particularly the functioning of the labor market, will have to be introduced.

The most essential task for economic policy for the period ahead is to hold back price and wage developments. This poses a major challenge for economic policy: how to keep cost and price developments under control in an economy characterized by a profitable industry operating close to full capacity, with relatively strong internal demand and low unemployment.

To obtain this, the authorities and the staff agree that fiscal restraint continues to be necessary.

At the same time, the Government has declared its willingness to forgo a planned increase in payroll taxes in 1988, provided that the social partners reach settlements whereby the wage level, including wage drift, rises only moderately during that year.

Regarding wage policy, this spring a major decision was also taken by the Government in proposing "cash limits" in the central government sector. In future negotiations on wages and salaries, the Government will make clear in advance the budget appropriations available for wage cost increases. Appropriations in the budget for wage increases will be raised only by the amount declared to be economically feasible. Any excess costs will have to be offset by measures to increase efficiency and productivity, or by expenditure cuts of other kinds. Municipalities and county councils will be encouraged to follow a similar approach.

The authorities also attach great importance to the supply-side measures that are being undertaken. Perhaps the most important of these measures is the continuing reform of the tax system. A broad consensus is developing in Sweden on the need for far-reaching changes in the present tax system. The three different Parliamentary Committees working on these issues will present their reports during 1988. The main objective of the income tax reform is to simplify the tax system and, at the same time, to make changes that would improve incentives to work and save. Such an improved system would be characterized by lower income tax rates, fewer deductions, and a more effective and neutral taxation of capital.

Not only is reform of the personal income tax system under discussion, but also reform of corporate taxation. There are strong reasons for considering a broader base and lower tax rates also for corporate taxation. This would contribute to an acceleration in the process of industrial renewal.

Furthermore, the Swedish Government is actively exploring new ways of increasing the efficiency of labor market policy. To this end, a number of measures were presented in this year's Revised Finance Bill for overcoming bottlenecks in the labor market and reducing unemployment among youth as well as reducing long-term unemployment.

The basic framework of monetary and foreign exchange policies is not to be changed. The overriding goal as regards the external sector is to establish a lasting current account surplus that will enable Sweden to reduce its stock of foreign debt--private as well as government. It is the official view that government net borrowing abroad is to be avoided. Sweden also intends to maintain the present system for fixing the value of the krona.

Extending his remarks, Mr. Ovi noted that according to the staff report, the authorities regarded the possible inclusion of the Swedish krona in the European Monetary System (EMS) as inconsistent with political neutrality. That statement was somewhat misleading. The authorities considered that there were sound economic reasons for retaining the present system of fixing the value of the krona: it was easy to comprehend, it was easy to operate, and it was accepted by all parties. Therefore, membership of the EMS was not at present considered attractive; however, Sweden had declared its intention to collaborate as closely as possible with the European Communities, for instance, to achieve a truly free market among European countries.

Mr. Grosche made the following statement:

During 1986, Sweden seems to have accomplished something all countries are striving for, but almost never reach. In Germany it is called the "magical quadrangle"--the simultaneous attainment of four economic goals: reasonable growth, price stability, external balance, and high employment.

Unfortunately, Sweden's achievements are at risk. Developments in 1986 were partly the result of one-time gains in the terms of trade, and the outlook for 1987 and beyond conveys a less "magical" impression. Present developments point to a resurgence of price inflation, reaching 4 percent in 1987. Moreover, with the terms of trade gains having run their course, an underlying deterioration of the external balance is likely to re-emerge, threatening the scope for maintaining satisfactory growth and employment.

I fully agree with the staff that two ways out of the dilemma faced by the authorities--external borrowing and/or devaluation of the krona--should be avoided because they might lead to greater difficulties in the medium and long term. I am glad to note that the authorities also reject these options. Thus, the medium-term scenarios demonstrate that competitiveness will have to be maintained through domestic action: the rise in prices and production costs has to be countered by measures aimed at holding down the increase in private consumption and wages.

I welcome that the authorities have already started to act. First and most important, they intend to maintain a restrictive fiscal and monetary policy stance. In addition, they are undertaking welcome efforts to restrain wage increases. Already last year the central wage settlement in the private sector had included a provision that almost half of any wage drift would be subtracted from the contractual increase in 1987. In view of this provision, I wonder how wage drift will respond in the remainder of the contractual period and, even more important, in 1988. I share the staff's apprehension regarding the next wage round, as the labor market is very tight and wage moderation may be difficult to sustain in these circumstances. There is, indeed, a question whether the intended wage moderation is possible without a lower pressure of demand from the start. More information on this issue--taking into account the effects of the price freeze--would be welcome. What are the prospects that the objective of limiting the increase in hourly earnings to not more than 3 percent in 1988 can be achieved? I note from Mr. Ovi's statement that the Government might be ready to forgo a planned increase in payroll taxes in 1988, if the social partners reach a satisfactory agreement on wages. I also welcome the Government's decision to put cash limits on public expenditure for wages, and to make it clear from the outset how much money will be available in future budgets for wage cost increases.

The authorities continue to support stable exchange rates--in terms of an official currency basket--by ensuring balance in the external currency flows. I share the staff's view that a monetary policy focused on stable exchange rates is heavily circumscribed as an instrument of demand management. In such circumstances monetary policy will stop accommodating domestically generated wage and price increases only after they start to threaten the external balance. Nonetheless, I agree with the staff that monetary policy could have a somewhat sharper cutting edge if the effective exchange rate was weighted more heavily in favor of low-inflation countries. The prominence now given to the U.S. dollar in the basket exceeds its weight in trade. At the same time, exchange rates affect the prices primarily of traded goods. Some adjustment in the basket may therefore be warranted.

The liberalization of credit markets has put interest rates in the forefront of monetary management. At the same time, it has led to an expansion of several financial flows whose dimensions were difficult to interpret and may have led to some misjudgments as to their impact. But these problems should be overcome in due time.

In concluding, I commend Sweden for its open market policies and for its foreign aid commitment on the order of 1 percent of GNP.

Mr. Templeman made the following statement:

The Swedish economy in mid-1987 is experiencing modest growth, low inflation, very low unemployment, a declining fiscal deficit, and rough external balance. Certainly, the overall economic performance and outlook are much improved over a few years ago. Nonetheless, some underlying trends are not altogether comforting. In particular, Sweden's growth performance may not be sustainable without a substantial increase in, and shift in the composition of, domestic savings and investment. With regard to inflation, labor market pressures may make it difficult to maintain price stability. As for the balance of payments, further improvement in the terms of trade does not seem likely; import volumes are rising more rapidly than export volumes, as Swedish exporters have been losing market shares.

The performance of the Swedish economy is determined to a large extent by the Government's labor policy. There is no doubt that the Government is committed to low levels of unemployment and to wage restraint. A variety of measures, including tax incentives, price controls, and budget ceilings are being attempted to contain wage increases. Yet, the rise in unit labor costs in Sweden is still relatively high compared with those of its trade partners. Therefore, wage restraint is important to maintain Sweden's international competitiveness and, thereby, to avoid further increases in external debt. In this regard, we note that hourly earnings in 1986 and 1987, including wage drift, are estimated to be higher for the public sector than for the private sector. We wonder how these figures can be reconciled with the authorities' wage restraint objectives and with the cash limits on central government wages referred to by Mr. Ovi. More generally, we agree with the staff and Mr. Ovi that wage moderation is difficult to achieve in a labor market as tight as Sweden's. Thus, it is important to ensure maximum labor market mobility and to foster investment so as to increase productive capacity.

The central issue for the Swedish economy may be the nature of its response to its tight labor market. More specifically, in view of Sweden's relatively small public sector, private firms that utilize labor more efficiently should be able to outbid those with lower productivity, so that productivity will rise when labor is in short supply. However, because of the limited extent of labor mobility within the public sector and between the public and private sectors, as well as the falling private savings rate and the high cost of capital, the prospects for raising productivity may also be less favorable. Mr. Ovi has noted that the authorities intend to introduce various measures to improve the functioning of the labor market, but it is possible that the most effective measure would be to reduce somewhat the size of the public sector. We would appreciate the staff's views on labor mobility.

Sustainable growth with relative price stability will also depend on adequate growth of productive capacity through shifts in the savings and investment pattern. Considerable progress has been achieved in strengthening the net savings position of the public sector by reducing its deficit by 8 percentage points of GDP between 1982 and 1987. Of the total deficit reduction, 4.5 percentage points will result from a decline in the expenditure ratio and 3.5 percentage points will be due to an increase in the revenue ratio. We agree with the proposed focus on spending cuts, although the staff papers have relatively little information on the composition of public expenditure, so it is difficult to see where further reductions might be made.

On the revenue side, we are encouraged by the steps taken toward tax reform and would agree with the objectives mentioned by Mr. Ovi. However, his statement gave the impression that the reform may be revenue neutral, whereas some reversal of the recent rise in revenues relative to GDP since 1982 might be desirable. Furthermore, the Finance Minister sketched out a tax reform proposal at the beginning of the year, which we assumed would lead to changes in 1988 or 1989. We were therefore surprised to read in the staff report that reforms would not be implemented before 1991. We wonder why implementation will be delayed.

While the rationale for maintaining a stable exchange rate is understandable, we agree with the staff that this policy stance is not sustainable, if the rate of inflation in Sweden continues to exceed that in its major trading partners. In view of the concerns expressed about the labor market, Sweden's exchange rate objective could prove to be incompatible with its employment objective.

I welcome the continued moves toward the liberalization of Sweden's financial markets, including some liberalization of international capital flows. Nevertheless, Sweden remains one of the most restrictive members of the OECD with respect to international capital movements, and I encourage the authorities to maintain the momentum of their liberalization efforts.

We were particularly interested in the discussion of the authorities' Medium-Term Survey. The dilemma of how to switch to a higher growth path without threatening the external balance appears to be the central challenge facing the authorities. It is also a matter of considerable interest to the world economy and to the Fund in its surveillance activity. Therefore, structural reform in the fiscal and labor market areas is likely to be crucial to any successful economic strategy for meeting this challenge.

Mrs. Ploix made the following statement:

The fall in oil prices and, to a lesser extent, the realignment of exchange rates had a favorable impact on the Swedish economy in 1986. Practically all the main indicators showed some improvement. Nevertheless, a relatively high inflation rate largely owing to excessive wage settlements remains an unresolved problem.

This unfavorable development, which is likely to have a bearing on the internal and external equilibria, is the single most important question to be addressed by the authorities. I will thus review various policy areas from this specific angle.

The authorities must be commended for the remarkable fiscal adjustment achieved over the last four years. The overall public sector position was in balance last year and should show a surplus in 1987, thanks in part to an exceptional levy on insurance companies. To the authorities' credit, this fiscal turnaround, equivalent to more than 6 percent of GDP, was accomplished through expenditure retrenchment. While fully recognizing the progress already achieved, I wonder whether fiscal policy could not contribute further both to easing inflationary pressures and to enhancing the savings behavior of households.

The fiscal consolidation process has not precluded a continued rise in the civil service payroll. If the relative shortage of manpower is a significant factor behind the existing wage pressures, then stabilizing the size of the public sector would facilitate labor mobility.

The recent drop in household savings to a negative rate helps to explain the persistent inflationary strains and could threaten the external position. Viewed against the background of the heavy tax burden--a distinctive feature of the Swedish economy--the savings behavior of households becomes more understandable. It is therefore interesting to note that the authorities have recently set up several commissions to review taxation with a view to reform. In this connection, I wonder if Mr. Ovi or the staff could comment further on the likelihood of a significant tax reform.

The sharp increase in monetary aggregates in 1986 and during the first half of 1987 seems to be mainly attributable to the far-reaching steps taken to modernize the financial system. As underlined by the staff, these most welcome structural changes have made some transactions, which were not captured in the previous regulatory setting, more transparent. However, some developments--more specifically, the liberalization of personal credit--can only give an additional boost to private consumption, which has already been stimulated by large wage gains. A more cautious approach might be warranted to avoid a further deterioration of the financial balance of the household sector.

Nonetheless, on the basis of prevailing interest rates, the monetary stance appears adequately firm. Although a more stringent approach could be supported in light of the persistent inflationary expectations, a stricter control over wage settlements seems a more promising way of dealing with this problem. Moreover, real interest rates are already high compared with those of other industrial countries, and a further narrowing of the margin between yields on real and financial assets could jeopardize the investment upswing that is now under way, which is needed to strengthen exports.

On exchange rate policy, I share the authorities' view on maintaining a stable exchange value for the krona. The role that such a stable exchange rate can play as an anchor for cost developments in an open economy like Sweden's has been amply illustrated in some other European countries. Obviously, the external competitiveness of the export sector has been adversely affected by the poor inflationary record since 1984 and by wage increases. Nevertheless, with the decline of the U.S. dollar, this deterioration has been partly reversed, and the overall competitive position of Sweden in some of its basic export markets does not seem in danger for the time being.

Mr. Hogeweg made the following statement:

The Swedish economy has shown a favorable performance since 1982. The authorities should be commended on their policies, which have resulted in satisfactory economic growth, a further increase in employment opportunities, a decline in inflation, the elimination of the current account deficit, and an enviable reduction in the Government's deficit.

The authorities are clearly aware that the results achieved are vulnerable. As Mr. Ovi has stated, the challenge facing the authorities is "how to keep cost and price developments under control in an economy characterized by a profitable industry operating close to full capacity, with relatively strong internal demand and low unemployment." Of course, there are no easy solutions. However, I fully agree with both the staff and the authorities that wage restraint is needed to maintain competitiveness so as to avoid a deterioration of the external position, and that a continued tight budgetary policy could contribute to that objective. I also agree that a devaluation of the exchange rate should be avoided since, given the tight labor market, it could only contribute to inflation and not to a better competitive position. Furthermore, I share the view that foreign borrowing by the authorities would not solve any of Sweden's problems.

It was striking that the rates of increase in hourly earnings in the public sector in 1986 and 1987 are higher than those in the private sector, including wage drift. That does not seem to be conducive to wage restraint in the economy as a whole. Also, the public sector has continued to absorb man-hours at a more rapid pace than the overall increase in the labor force. Although it is understandable that the creation of sufficient employment opportunities has a high priority, even though the unemployment rate is low indeed, I wonder whether job creation does not aggravate the problem of achieving wage restraint in the context of a tight labor market.

The related, more general question of the size and structure of the public sector is notably absent in the staff report. The share of the public sector in GNP is higher in Sweden than in other industrial countries, and marginal tax rates are very high. By contrast, the report on the latest Article IV consultation with the Netherlands (SM/87/6, 1/6/87) indicated that the "excessive" size of the public sector was an important factor contributing to a less satisfactory performance of the Dutch economy. Does the staff also see the size of the Swedish public sector as having adverse effects on the country's economic performance?

The envisaged tax reform measures figure much less prominently in this year's staff report than last year's, although Mr. Ovi did mention them in some detail. A broader tax base with lower tax rates could certainly contribute to better incentives in the economy. Also, a much needed rise in the private sector's savings ratio might be stimulated by a tax reform. It is disappointing that the preparation of these reforms by the authorities has been structured in such a way that their implementation cannot be expected for many years to come.

I believe the staff rightly endorsed the authorities' exchange rate policy, which aims at stabilization. Like Mr. Grosche, I noted with interest the staff's statement that this policy would do more to moderate domestic inflation if the effective exchange rate was weighted more heavily in favor of low-inflation countries. Mr. Ovi has just amended the Swedish argument of political neutrality with respect to EMS participation. Nevertheless, perhaps Austria could serve as an example for Sweden. Although not a formal participant of the EMS, Austria gears its exchange rate policy explicitly toward the deutsche mark. Another example might be Sweden itself, which, as mentioned in Appendix I of the staff report, was associated with European common margin arrangements before August 1977.

I wish the Swedish authorities success in their efforts to retain external balance via domestic rather than external measures.

Mr. Lim made the following statement:

The performance of the Swedish economy continues to be impressive. The fall in inflation, the improvement in the overall external position, and the maintenance of an unemployment level--already one of the lowest in the industrial world--and positive real growth simultaneous with the substantial improvement in fiscal balance and the net reduction in external indebtedness are remarkable achievements. They are no less impressive if account is taken of favorable external factors, for instance, the declines in oil prices and in international interest rates.

The only problem facing the authorities at this time is how to sustain this good performance. In this regard, I am encouraged by Mr. Ovi's statement reiterating his authorities' commitment to the economic policy that has enabled Sweden to maintain her place among the highest per capita income countries. I also fully agree with Mr. Ovi's emphasis on restraining increases in wages and prices, since enhancing external competitiveness is crucial if Sweden is to pursue its goal of maintaining high employment and establishing a lasting current account surplus that will enable a reduction of the stock of foreign debt.

Indeed, in 1986, labor costs rose much more rapidly than in competitor countries, thereby contributing to the loss of market shares both at home and abroad. That rise may also partly explain the shift in the source of growth from investments to public and private consumption during the year. Clearly, if this trend is not reversed, the higher import demand that could develop will, in the absence of a favorable terms of trade environment, necessitate greater wage restraint, especially since the authorities have ruled out the possibility of exchange rate adjustment. The situation is not made easier by the continued improvement in the unemployment rate and the authorities' reluctance to risk adding to unemployment, the "close-to-full" capacity utilization of industry, and the extremely low savings propensity of the private sector. Clearly, fiscal and monetary policies will have a crucial role to play in influencing wage settlements, improving industrial efficiency, and encouraging a higher private sector savings rate.

I agree with Mr. Ovi's views on broadening the tax base and lowering corporate tax rates. Despite the limited scope for changing personal income tax rates, there may be room for reform of the tax structure so as to encourage higher household savings. It is therefore encouraging to note that efforts are under way to effect far-reaching changes in the present tax system. Could the staff elaborate on why the tax reform cannot be implemented until 1991.

On monetary policy, I note that the growth of the money supply exceeds historical levels and could contribute to inflationary pressures if the price freeze is not dismantled.

On trade policy, I fully share the authorities' concern about the spread of protectionism abroad, particularly the discriminatory levy imposed by the United States on imports of special steel products from countries which did not sign a voluntary export restraint agreement. I recall that in the Board's recent discussion on the supplemental consultation with Korea (EBM/87/97 and EBM/87/96, 7/6/87), the U.S. chair made clear that its authorities did not seek such voluntary export restraints. Could the staff comment on the circumstances in Sweden's case?

Finally, I am particularly pleased to note Sweden's support for liberal trade relations, its duty-free treatment of all imports originating in least-developed countries, and especially its commitment to keep ODA appropriations fixed at 1 percent of gross national income. These policies place Sweden at the forefront of the global effort on trade and development that the Fund's Board has consistently called for.

Mr. McCormack made the following statement:

Since the last Article IV consultation with Sweden (EBM/86/134, 8/8/86), economic performance has been relatively good. In particular, in the first part of 1987 there has been a pickup in growth, a decline in unemployment, and approximate balance in the current account. However, questions arise about the sustainability of the present situation, largely because of the recurring issue of wage and price increases and their impact on international competitiveness. I agree with the staff and the authorities that any attempt to enhance international competitiveness through a currency depreciation would be counterproductive. In this situation, structural reform and fiscal and monetary policies have to be framed so as to encourage moderation in wage and price increases. If competitiveness deteriorates, there would be a distinct risk of a worsening in the current account and relatively weak growth in the years ahead.

The authorities are attempting to establish a relative real wage level consistent with a very low natural rate of unemployment. The central question is how can this be achieved. Forgoing the planned increase in payroll taxes in 1988--provided that the social partners agree to an appropriate pace of wage increase--is a helpful step, to the extent that the fiscal position is not thereby threatened. In addition, I would encourage the authorities to continue the process of removing rigidities in the labor market, which should help to increase the responsiveness of the supply of labor to changes in demand.

The authorities are relying mainly on discussions with the social partners regarding the likely consequences of different wage scenarios, such as those of their Medium-Term Survey, in order to reach a low, sustainable rate of unemployment. This approach may well be effective in view of the sophistication demonstrated by Sweden's social partners in the past. At the same time, however, the policy goals are ambitious and might easily conflict. Consequently, if wage restraint does not materialize, greater fiscal restraint may be necessary than is presently envisaged, in order to achieve the authorities' policy objectives concerning external debt and inflation.

More generally, I agree that the orientation of fiscal policy needs to be restrictive in order to moderate demand and ease cost and price pressures. The focus on expenditure restraint is appropriate, particularly in light of the high level of taxes and the fact that tax increases may be translated into higher wage demands. In addition, the fiscal authorities have a direct role to play in the area of wage moderation by taking a firm line on public sector pay. This can have a useful demonstration effect on the rest of the economy. Also, I welcome the continuing efforts to reform the tax system, as outlined by Mr. Ovi, and I look forward to the reports which are expected in 1988. I would also be interested in the authorities' expected timetable for implementation of the reform.

The commitment of the monetary authorities to resist inflation is proper, and I agree that monetary policy should not accommodate excessive wage and price increases through exchange rate depreciation. In its appraisal, the staff has argued that a monetary policy focused on exchange rate stability will actively resist wage and price increases only after the emergence of a threat to the external balance. This is true, but ultimately the effectiveness of a monetary policy aimed at stabilizing the price of a given currency basket depends on empirical aspects of the economy, including its openness, the degree of capital mobility, the role of exchange market expectations, and the interest sensitivity of the demand for money and of consumer and investment spending. I wonder if the staff could comment on some of these considerations, particularly with respect to the appropriateness of Swedish monetary and exchange rate policy.

Finally, we are encouraged by the continuing Swedish commitment to trade liberalization, and we commend the authorities' commitment to a foreign aid level equivalent to 1 percent of GNP.

Mrs. Filardo made the following statement:

I commend the authorities for their successful economic management, which has resulted in a satisfactory performance since the last Article IV consultation with Sweden. Economic growth has risen, and the external account is balanced. Furthermore, unemployment is extremely low, in sharp contrast with the situation prevailing in most other European countries. In addition, the marked strengthening of the profitability of enterprises has been reflected in a recovery of industrial investment and the overall financial situation of the public sector.

The authorities should be especially commended for their continued concern for the difficulties of developing countries, particularly the low-income countries. We are pleased to note the authorities' continued commitment to maintaining a high level of foreign aid and to actively seeking a reduction in worldwide protectionism.

The room for improving economic policy is limited when the economy has been performing so well. Industry is operating at profitable levels, and there is close to full employment with low rates of inflation. Under these circumstances, the challenge for economic policy is how to keep cost and price developments under control, particularly in view of strong domestic demand. Both the staff and Mr. Ovi have indicated that the authorities are aware of the need to maintain and strengthen their present course, and they are likely to succeed in doing so.

Demand management policies in an economy with close to full employment ought to be designed to prevent the emergence of high rates of inflation. This is not an easy task in Sweden's present circumstances. To keep inflationary pressures under control, trade unions' demands for increases in nominal wages that exceed increases in productivity must be resisted. There are three possible ways to accomplish this. One possibility is negotiations among social partners. The Government has already stated that to maintain a competitive inflation differential, wages and salaries cannot increase by more than 3 percent. A second way would be to increase taxpayers' disposable income through a reduction in taxation so as to encourage increased private savings. However, an increase in private savings should not be accomplished entirely at the expense of public savings. The third possibility would be to reduce inflationary pressures through the use of traditional, restrictive demand management. This is particularly important when a deterioration in external competitiveness leads to current account problems. Smooth economic management should avoid the need for corrective measures in the future. Moreover, in addition to achieving a low rate of inflation, policies geared to controlling inflationary pressures should aim at reducing inflation differentials with foreign competitors.

To maintain the current outstanding performance in the external sector, a weakening of the current account must be avoided. To this end, Sweden should increase its international competitiveness without resorting to exchange rate actions. The reduction of inflation differentials vis-à-vis main competitors through wage restraint is crucial in this regard. Keeping inflationary pressures under control is also desirable to attain the exchange rate target. The use of the interest rate to achieve balance of payments and exchange rate objectives should be limited to the very short term. Permanent recourse to this instrument could induce an erratic interest rate behavior in this context, which would not only send misleading signals to the economic agents, but could also discourage investment. Interest rate policy and foreign exchange market interventions are not substitutes for balanced domestic macroeconomic policies.

Mr. Hospedales made the following statement:

The Swedish economy, helped by a favorable external environment in 1986--including lower petroleum prices and somewhat lower international interest rates--has continued to perform relatively well following the adoption of a comprehensive economic strategy in 1982. In a technically sound appraisal, the staff has highlighted the principal successes--falling unemployment, an improving real GDP growth rate, and a substantial turnaround in the public sector deficit--as well as the areas of vulnerability and uncertainty--unfavorable developments in wage and price formation, and an underlying deterioration in the external current account balance. These latter factors could, in the staff's view, threaten the scope for attaining the authorities' key objective of maintaining satisfactory growth and employment without net external foreign borrowing.

The challenge for Sweden, therefore, is to ensure that these unfavorable developments do not undermine the central element in the current economic strategy--the promotion of investment and net exports. It is therefore especially noteworthy that the public sector deficit has been scaled back significantly. Strict adherence to this strategy will ensure a public sector saving, which will facilitate an interest rate structure consistent with an expansion of investment and net exports.

Additionally, there is an urgent need to reverse the erosion in trade competitiveness in view of the recent serious losses in Sweden's market shares. However, the need to reconcile the objective of full employment with reliance on market forces so as to keep overall wage increases in line with competitive requirements poses a difficult policy dilemma. One option is for the authorities to exert greater influence on social consensus building in the wage formation process and to continue promoting flexibility in the labor market--an objective underscored earlier by Mr. Ovi. In this respect, the present monetary stance aimed at stabilizing the exchange rate has been extremely helpful in avoiding the validation of wage increases.

Sweden's strong commitment to trade liberalization and official development assistance is commendable. We welcome the recent initiatives to facilitate trade with developing countries and look forward to an eventual easing of trade restrictions on agriculture and textiles, two areas of particular importance for developing countries, including the poorer ones. Increasing ODA by 10 percent, which raises Sweden's commitment to the equivalent of 1 percent of GDP, is an exemplary approach to international economic cooperation in light of the 0.7 percent of GNP target for ODA recently reconfirmed at the Venice Summit and of Sweden's own strong fiscal retrenchment.

Mr. Zecchini made the following statement:

Positive but fragile results characterized the performance of the Swedish economy in 1986. The current account shifted to a surplus, mainly owing to a terms of trade gain that is unlikely to recur in 1987, while import volumes continued to grow faster than exports. The unemployment rate was slightly reduced, but conditions in the labor market continued to tighten, exerting additional upward pressure on wages. The public sector financial deficit declined, but mainly because revenues were higher than expected.

The two major areas of weakness continue to be the external account and the dynamics of wages. Adjustments in both areas will be essential in order to achieve balanced, noninflationary growth in the coming years.

The authorities' commitment to achieve a surplus through a tightening of fiscal policy seems warranted for two reasons: to slow down domestic demand expansion in order to reduce pressure on wages, and to increase public savings and contribute to a surplus in the external account. Improvements should mainly derive from expenditure reductions rather than revenue increases. Efforts should particularly aim at containing the expenditures of the local authorities. In fact, whereas the financial balance of the Central Government has been improving continuously in the last few years, the balance of the local authorities has swung into deficit since 1983 owing to high wage awards.

On the revenue side, we welcome the authorities' intention to consider some major tax reform. As we said on the occasion of the 1986 Article IV consultation with Sweden, the authorities should aim at reducing the tax burden, and not just preventing its increase. The revenue to GDP ratio has been edging up continuously in the last few years, in spite of the income taxation reform in 1983-85; this ratio is still well above the industrial countries' average. It is widely recognized that such levels of taxation may act as a disincentive to savings and investment.

The monetary policy stance adopted in 1986 seems broadly appropriate. Short- and long-term interest rates were allowed to move in response to changing developments in capital flows. In view of the unfavorable trend in the external account and the rise in inflation in the coming year, monetary policy must continue to remain tight in order to check domestic growth and stabilize exchange rates. With respect to the latter objective, we wish to stress the importance of maintaining a nonaccommodative exchange rate policy stance to strengthen the action of other domestic policies in view of the objective of stemming price and wage pressures.

Labor market policies and developments will continue to deeply affect the evolution of external competitiveness and the current account. Both external competitiveness and export performance have deteriorated in the last two years as relative unit labor costs have increased steadily. In fact, given the stability of the nominal exchange rate, the faster growth of wages vis-à-vis those of trade competitors has eroded external competitiveness. The result has been a declining rate of growth of export volumes and continued erosion of market shares.

In view of the weak growth of world demand for Sweden's exports in the coming year and of the authorities' commitment to a nonaccommodative exchange rate policy, improvements in export performance will have to come mainly from improvements in price competitiveness. To this end, it is essential that in the coming year, labor cost increases be maintained in line with the rate of increase in major trading partners, which is estimated to be about 3 percent on the basis of a trade-weighted average. In 1987 the increase in hourly earnings is expected to be reduced to about 5 percent, which is well below the 8 percent increase in 1986, but still in excess of increases in competitor countries.

Several factors account for Sweden's higher wage increases. One factor is the collapse of the so-called Scandinavian Model of wage determination, which should be viewed in the light of the increasing proportion of workers employed in the public sector. Whereas in the past, wage increases in the tradable goods sector were determined by taking into account international competitiveness and then extending these increases to the public sector, the reverse seems to be occurring now. A second important factor is tight labor market conditions: at present the unemployment rate is very low, particularly compared with the rest of the world, and the number of vacancies has been high and is growing. A third factor is the improvement in enterprise profitability following the devaluations of the early 1980s. According to a recent OECD study, high profits may lead to wage increases by weakening the resistance of employers to wage demands.

In conclusion, the need to foster the growth of net exports and ultimately to create the conditions for a sustained growth of Sweden's economy requires a much firmer control over cost and price developments to keep them in line with external trends. To this end, we support the authorities' intention to continue to utilize negotiated income policies as a major instrument to check wage increases. In addition, more efforts are needed to improve mobility in the labor market. The importance of maintaining wage discipline in the public sector must also be stressed. In this connection, we welcome the proposal to set cash limits on the central government wage bill in fiscal year 1987/88. Finally, in the event of slippages in the achievement of incomes policy objectives or of unexpected unfavorable external developments, the authorities should be ready to implement demand restraint measures to affect indirectly wage dynamics. The present, very low unemployment rate--even by Swedish standards--allows some scope for a tightening of demand policies.

Mr. Fernando made the following statement:

We commend the Swedish authorities on their impressive record of economic management, which has advanced the prospects of balanced growth, promoted price stability, ensured almost full employment, and preserved the social gains of the past. In the coming year, the focus will be on wage developments across the economy. The authorities' Medium-Term Survey indicates that restoration of balanced growth in the context of the current policy stance would be ensured only if wage costs do not outstrip developments elsewhere. We appreciate the authorities' efforts to derive a social consensus on the corrective policies required by subjecting the Medium-Term Survey to public debate.

As the labor market is already tight, wage moderation will be an exceptionally difficult task. The 8 percent rise in hourly earnings in 1986 and the projected 5 percent increase for 1987 are well in excess of rates in competitor countries. The importance attached by the authorities to maintaining a stable exchange rate and to reducing external debt underlines the need to contain wage costs so as to support the balance of payments through maintaining export competitiveness and restraining real imports. The other option--increasing investment to relieve the pressure on capacity utilization--will, of course, take longer to work its way through the system.

In evaluating the latter option, the burden placed on budget policies to spearhead the domestic savings effort should be taken into account. Regrettably, the capacity of local government authorities to contribute to public sector savings has been impaired recently owing to expenditures induced by wage increases. Household savings, particularly financial savings, are constrained by the burden of taxation, which is 20 percentage points higher than the industrial country average expressed in terms of GDP. The motivation to save should also make due allowance for Sweden's elaborate social security system, which has minimized many of the risks against which provisions are made for the future. Further improvements to the social security system are planned, and we hope that the authorities will trade these benefits in setting the wage line. This will also help the private sector, which has already agreed to a price freeze and a price supervision scheme, to determine its stance. The Government's determination to reach its objectives--as was evident in the recent action to reduce budget transfers to one part of the system when a proposed reduction to another part was defeated in Parliament--is particularly welcome.

We recognize the authorities' efforts to ensure a degree of compatibility between their trade policies and the growth-oriented adjustment policies of less developed countries, as well as their financial support, especially to lower-income countries. We attach importance to their actions to keep Swedish markets open to imports, especially those of least developed countries, under attractive terms. We also appreciate the authorities' contribution in pressing for a standstill and rollback of protectionism under a new GATT round. Sweden's actions to restructure its own industries, particularly the textile and shipbuilding industries, is a source of encouragement for those developing countries attempting to diversify exports on the basis of comparative cost advantage. Finally, Sweden's consistently good record in respect of ODA, which is equivalent to 1 percent of GNP in the 1987/88 budget, deserves special commendation.

Mr. Foot commented that he agreed with remarks by other speakers on the importance of wage moderation and tax reform. With regard to tax reform, he wondered what was the appropriate balance between sectoral saving patterns in view of Sweden's comprehensive social security network.

The progress on financial deregulation since 1980 was welcome, but further steps should be taken; for example, the removal of controls on the purchase of foreign securities, Mr. Foot continued. That the early performance of the futures markets in Sweden had exceeded all expectations was only one indication of the potential impact of deregulation on financial markets.

Finally, he agreed with other speakers that the authorities should remove the system of price controls as rapidly as possible, Mr. Foot remarked.

Mr. Rouai made the following statement:

In 1986 GDP growth declined for the second consecutive year, reaching 1.3 percent, compared with 2.2 percent in 1985 and 4 percent in 1984. As in 1985, economic growth was generated mainly by consumption, which contributed 2 percentage points to GDP growth. The contribution of the external sector and investment--the major stimulus in 1982-84--was negative.

Despite sluggish growth, the Swedish economy continued to perform relatively well. Welfare indicators in terms of GDP per capita and life expectancy remain among the highest in the world. Unemployment and inflation rates abated to 2.7 percent and 3.2 percent, respectively, compared with 3.5 percent and 9.3 percent, respectively, in 1983.

Since I am in broad agreement with the staff appraisal, I will focus on some specific policy areas.

Sweden's policy on international trade and official development assistance deserves great respect; ODA in fiscal year 1987/88 is fixed at 1 percent of GNP, an increase of 10 percent over 1986/87. Several measures to facilitate trade with developing countries are also being implemented. The authorities are to be commended for their continuous support to developing countries, particularly at this crucial moment when their economies are characterized by heavy indebtedness and trade imbalances.

As recognized by the Swedish authorities, the main task of economic policy is to restrain wage pressures in order to restore competitiveness. In a small, open economy like Sweden's, this goal is very important to achieve. Although the increase in hourly earnings is projected to decelerate from 7.4 percent in 1986 to 5.4 percent in 1987, it remains relatively high compared with the rate of increase in competitor countries. In view of this and Sweden's high capacity utilization and tight labor market, wage moderation may be exceptionally difficult to sustain.

With regard to fiscal policy, the adjustment already achieved is commendable. The public sector deficit declined from 6.3 percent of GDP in 1985 to 0.7 percent of GDP in 1986, and a surplus is projected for 1987. However, this consolidation is the result of a reduction in expenditure rather than an increase in revenue. Total expenditure as a share of GDP declined from 67.4 percent in 1985 to 63.8 percent in 1986.

The reduction of the public sector deficit increased gross domestic savings. Household savings, however, continued to fall despite the rise in real interest rates and in real disposable income. The deregulation of the credit market for consumers in

November 1985 contributed largely to the decline in household savings. As a result of deregulation, total domestic credit expanded from SKr 89 billion in 1985 to SKr 185 billion in 1986, leading to an increase in M3 by 10.9 percent. Although this increase largely represented a reintermediation of financial flows from the gray market, the excess liquidity could increase inflationary pressures and reduce the room for maneuver at the time of the next wage round.

Mr. Ovi has correctly emphasized the need for a further reduction in the budget deficit and for additional efforts to constrain prices, wages, and private consumption. In this regard, the introduction of cash limits for wage cost increases in the central government sector along with the need for further improvement in productivity to offset any excess costs are steps in the right direction. We also welcome the consensus on the reform of the tax system.

Mr. Yamazaki made the following statement:

The performance of the Swedish economy in 1986 was commendable. Despite the sluggish GDP growth, the unemployment rate remained low by international standards. The current balance shifted to a surplus amounting to 0.6 percent of GDP, largely owing to low oil prices and interest rates. The further retrenchment of the fiscal deficit, which has been achieved mainly through expenditure cuts, is also commendable. As a result of the considerable emphasis placed on public sector consolidation, the fiscal deficit fell sharply last year, largely offsetting the decline in private sector savings.

Despite these favorable developments, some worrisome factors still remain. Specifically, economic growth, based on expanding exports and investment, has deviated from its original path. Sweden's external debt is high compared with that of other industrial countries, and it is imperative to maintain a strong external position and sustainable growth in order to reduce the stock of debt. I therefore support the authorities' growth strategy, but am concerned about the negative contribution of the external sector to growth and about the decline in gross fixed investment in 1986.

Wage policy has a vital role to play in attaining a viable external position. On the supply side, the large increase in wages since 1984 has pushed up costs and has consequently led to the loss of international competitiveness and market shares of tradable goods. On the demand side, the wage increase has boosted domestic private consumption. It is, of course, difficult to achieve wage moderation in an economy with a tight labor market and a high labor force participation ratio. However, wage policy is a key variable in the Swedish economy, and further effort is required in this area. I therefore support the envisaged tax rebate and the setting of cash limits for wage increases as short-term measures to restrain wages. Serious consideration should also be given to some structural measures aimed at increasing labor mobility in the medium term, particularly with a view to mitigating the shortage of skilled labor. I welcome Mr. Ovi's statement on the measures included in this year's revised Finance Bill, but much remains to be done in this area.

Wage moderation must be supported by adequate pricing and demand management policies. Price pressures should be subdued and should not give rise to inflationary expectations. In this context, the authorities' flexible approach, as evidenced in the implementation of the price freeze in January, is noteworthy. Nonetheless, the expected inflation rate of 4 percent in 1987 is high relative to the level prevailing in Sweden's trading partners, and is still worrisome.

Investment is another important area of concern. Although the staff views the decline in gross fixed investment in 1986 as temporary, in my view, steady capacity expansion is necessary in view of the constraints that have already emerged in some areas. As interest rate policy is geared to stabilize the exchange rate, tax reform may serve to encourage investment. These factors should be taken into account in formulating the tax reform now under consideration, and I look forward to its early implementation.

Finally, I generally support the authorities' policy strategy and the staff appraisal.

Mr. El Kogali commended the authorities for managing their economy well, for maintaining a low level of unemployment and inflation, and for pursuing a liberal trade policy, and indeed, promoting that stance in international forums. In particular, he applauded their allowing exports originating from least developed countries duty-free access to the Swedish market. He also commended their efforts in the area of official development assistance; at 1 percent of GNP, Swedish ODA was well above the UN target of 0.7 percent of GNP, which had been reaffirmed by other industrial countries at the Venice Summit.

Mr. Prader made the following statement:

Sweden is one of the few industrial countries in the 1980s which has stuck to its goal of maintaining full employment while implementing an economic strategy suited to this task. In contrast to the new mainstream of economic thought originating in the mid-1970s, the Swedish authorities have demonstrated that an economy can have full employment with equilibrium in other major areas of macroeconomic policy. To be sure, the timing of the mix of policy measures that lay at the root of this strategy--massive devaluations in 1981 and 1982 coupled with fiscal retrenchment and a tight incomes policy--has benefited from some fortuitous factors, such as the decline in oil prices and interest rates as well as the recovery of the world economy. Nonetheless, such benefits can only be exploited fully by a competent economic management like Sweden's. The overall strategy has remained intact in its essentials and must be considered successful when measured against its original objectives of reversing the trend in the unemployment rate and boosting production and investment. The inflation rate, although higher than that in Sweden's main trading partners, has been brought down; the fiscal deficit has been drastically reduced; and the current account has reached an equilibrium position.

Surprisingly, only a fraction of the large gains in competitiveness achieved by the devaluations has been eroded by wage pressures. The staff's data indicate that, in terms of unit labor costs, only some 6 percentage points of the original relative cost advantage gained by the 26 percent devaluation has been lost. This is evidence of the remarkable social consensus in Sweden, which has held up despite severe strains. Above all, this outcome is due to the self-restraint of the trade unions, which have borne the brunt of the adjustment costs and--as the process continues--risk an escalation of tensions within their organizations. It may well be that Sweden's carefully designed strategy will unravel over time as a result of pressures on the trade unions.

Yet the upward trend in labor costs has become worrisome in view of the deterioration of Swedish competitiveness since 1984 and a loss of export market shares since 1985. The decline in competitiveness is due both to more rapid wage increases and decreasing productivity. In view of the central role that the Government's medium-term strategy assigns to net exports and to business fixed investment, which were also damaged by the rise in labor costs, it is vital to restrain domestic cost pressures.

The scope for dampening wage pressures is obviously limited, both by the tight labor market and by the Government's commitment to full employment. Also, the general success of efforts to curb the central government budget deficit has not left much room for fiscal policy to exert further downward pressure on wages. For these reasons, the greatest importance attaches to the implementation of the measures contemplated for giving some guidance in the next round of wage negotiations and controlling wage costs in the public sector. Demand restraint might be further supported by fiscal retrenchment on the part of local governments, whose fiscal adjustment has not kept pace with efforts at the central government level.

The restraint of domestic demand and cost pressures also depends critically on the conduct of monetary policy. In particular, the approach of moderating wages and prices through a stable exchange rate framework could be reinforced by changing the composition of the effective exchange rate to favor countries having a strong preference for price stability.

In this context, it may be relevant to question the authorities' concept of stable exchange rates, since the weight of the U.S. dollar in the Swedish currency basket is equivalent to twice the actual U.S. share in Swedish foreign trade. Thus, the specific construction of the basket reflects fluctuations in exchange rates based on trade shares only to a limited extent. In view of the declining value of the U.S. dollar, this is tantamount to a sizable depreciation of the Swedish krona against the deutsche mark bloc of European currencies.

On incomes policy, Mr. Ovi's list of measures designed to hold down wage increases was most interesting. Tighter incomes policies could indeed compensate for the limited room for maneuver of fiscal and monetary policies, if they were not constrained in the long run by their adverse effects on the trade unions.

Finally, the success of the Swedish economic strategy with its emphasis on maintaining full employment is striking, particularly in view of the surplus of the social security system. In countries where unemployment has risen markedly, the social security systems are facing a crisis; the substantial and aggravated deficits registered by their welfare schemes can only be reduced by cutting benefits and/or by raising social security contributions, with a consequent negative impact on the social consensus. The Swedish authorities have avoided such a crisis and should be congratulated on their success in designing a strategy to restore full employment.

The staff representative from the European Department, commenting on the prospects for achieving wage restraint in 1988, observed that while past trends were not encouraging, the authorities were trying to break the trend, largely through moral suasion. If they succeeded in doing so during the next wage round, it would be a remarkable achievement. The price freeze was intended to encourage trade union restraint, although it might also introduce some distortions. The authorities were therefore reluctant to continue the price freeze for a long period of time and had already begun to relax it in return for pledges on the part of enterprises to exercise restraint in the remainder of the year.

Another factor being watched with concern was the increase in public sector wages, which was expected to exceed increases in the private sector, the staff representative continued. The authorities had announced that, if necessary, they would place cash limits on the wage bill in the next government budget, but at present, they preferred to rely on persuasion. The next round of negotiations in the public sector would be particularly interesting in light of the authorities' fallback position.

The authorities had also encouraged restraint by promising to consider rescinding the 1 percent increase in payroll taxes if substantial moderation was shown in both the private and public sector wage settlements. The alternative was a further tightening of fiscal and monetary restraint.

The size of the public sector was being reduced, at least at the central government level, the staff representative commented. The local authorities were being encouraged to follow the Central Government's example through a reduction in the subsidies paid to local authorities in the coming year and through moral suasion. The increased employment on the local level was largely in the health services. While it was difficult to quarrel with that social choice, the effect of government spending would have to be measured against the success in attaining other equally urgent objectives, for instance, wage restraint. In that regard, the forthcoming tax reform was of considerable interest. The authorities wanted to study in depth whether some of the wage pressures and lack of savings were traceable to a heavy tax burden. Those studies partly accounted for the delay in formulating and implementing the tax reform.

It had been suggested that monetary policy should be tightened further, the staff representative recalled. However, the real rate of interest in Sweden was among the highest on record, so that the desirability of a further tightening was at least debatable. High interest rates had resulted in considerable currency flows from abroad in the first quarter of the year, which had led the authorities to reduce the interest rate. Sweden's interest rates still exceeded, by a margin, those of its trading partners. It appeared that monetary policy would have to be supported forcefully with fiscal policy measures to achieve domestic demand restraint.

The role of exchange rate stability in restraining inflationary pressures depended in part on the expectations of actors in the economy, the staff representative remarked. The authorities, particularly the Minister of Finance, had been tireless in explaining to all participants what would happen to the balance of payments, employment, investment, and long-term growth trends if inflationary pressures were not restrained. The authorities hoped to influence expectations more vigorously and to impress upon economic actors the balance of payments implications of their actions before any adverse consequences materialized.

In the authorities' view, an exchange rate basket based strictly on trade weights would not capture a range of relevant transactions, particularly in services, the staff representative explained. Account also had to be taken of the fact that the markets supplied by Swedish exports were not all denominated in the currency of the country of destination; for instance, world market prices for the pulp and paper industry and for the timber industry tended to be sticky in dollars.

On labor market mobility, there was considerable movement between the public and private sectors through the various public sector programs to help unemployed workers retain their skills so that they could re-enter the labor market quickly when the demand rose, the staff representative commented. Those programs had been a major source of labor supply to the private sector during the upswing since 1983. It was argued that in the absence of those public sector programs, the number of hard-core unemployed would have risen; instead, the programs allowed the unemployed to maintain their flexibility and re-enter the labor force with minimum difficulty.

In that regard, a distinction should perhaps be made between the total pressure on the labor force and the composition of the demand for labor, the staff representative from the European Department observed. If the overall pressure on the labor market was excessive--whatever the country's compositional preferences--tighter fiscal or monetary policy would be called for. Such tightening should perhaps be effected through cash limits, say, on employment in the public sector: if wages rose too rapidly, employees would have to be dismissed. In fact, Sweden's revised Finance Plan implied such a course of action if sufficient wage restraint was not achieved.

Mr. Ovi recalled that Directors had suggested three reasons for income developments in Sweden: the collapse of the "Scandinavian Model," the tight labor market, and high profits. In fact, the wage leaders in Sweden had not been the sectors with high profit ratios, but rather the sheltered sectors--the construction and government sectors. As for the tightness of the labor market, although the unemployment rate was below 2 percent at present, the overall unemployment rate--including those employed under various job creation schemes--was about 5-6 percent. The overall rate had decreased in recent years, which implied that a labor reserve within those schemes had entered the market within the past two or three years. Thus, while the labor market was tight, there was still some reserve.

As regards the collapse of the Scandinavian model, it should be pointed out that the gains following the devaluation in 1982 were to a large extent intact, Mr. Ovi continued. Moreover, if the wage cost increase remained at about 5-5 1/2 percent, it would be close to the average of other industrial countries. The question was how to attain the authorities' objective of a 3 percent rate increase. For that purpose, emphasis was being placed on two points: the wage drift in the private sector and the public sector wage increase.

Wage drift in the private sector was highly institutionalized and therefore remained at basically the same level, notwithstanding the pressure in the labor market, Mr. Ovi noted. The innovation adopted the previous year, whereby a part of the wage drift above a certain level was deducted from the contractual increase, seemed to be working so far. There were indications that the negotiated part of wage drift was lower in 1987 despite an even tighter labor market. The Government was trying to persuade all parties that achieving the objectives outlined in the Medium-Term Survey might be the best way to secure a fairly high increase in real wages. The labor unions seemed to understand that point, but the outcome of wage negotiations was still uncertain. Two other factors favored a satisfactory outcome: trade unions in Sweden placed a greater value on extra employment than on higher wages; and a solidaristic wage policy meant that relative wages could not be changed easily, and in that respect, trade unions themselves were strongly opposed to wage drift.

Wage negotiations in the public sector were cause for concern, Mr. Ovi added. An agreement reached in 1986 despite massive strikes had secured a settlement somewhat below that reached in the private sector, with no provision of automaticity to catch up vis-à-vis the private sector. The higher public sector wage increases over a three-year period represented a catch-up effect, which clearly was recognized as needed. In that regard, the latest increase was viewed as a once-and-for-all catch up.

The aim for the coming year was to decentralize the wage negotiation process in the public sector, Mr. Ovi explained. Those being allocated budgets would be made responsible for wage negotiations within their area, subject to cash limits, and would have to bear the burden of the outcome, which might mean firing people over time. The authorities were trying to make the public sector more responsive to the overall state of the economy, especially as real wages had proven to be flexible, as demonstrated by the devaluation, whereas relative wages had proven to be very inflexible.

On tax reform, the authorities' aim clearly was to reduce marginal taxes by broadening the tax base, Mr. Ovi commented. However, it was too early to tell whether the reform would be revenue neutral or whether particular attention would be paid to the size of the public sector. The committee on tax reform would make its reports in the coming year, and measures would be put to Parliament in early 1989. There was strong agreement on how the system should be changed; however, trade unions would have to be convinced not only about the incomes policy but also the distributional effects of changes in the tax system.

In the debate in Sweden on the need for a further tightening of the central government budget, it had been argued that since the deficit was coming down more rapidly than expected, there was some room for relaxing fiscal policy, Mr. Ovi noted. However, the Minister of Finance considered that there was no room for easing the fiscal stance, given the tightness of the labor market, and that savings should not be reduced. In that respect, it should be noted that the general pension scheme, which was at present in substantial surplus, would shift to a deficit over the coming years. That in itself would require substantial further tightening of central government finances.

The most pressing problem facing the authorities at present was the unusual degree of optimism in sectors of Swedish society, Mr. Ovi concluded. It was a major educational task to convince the public that even though the current account and budget were in equilibrium, there was a need for a further tightening of economic policies.

The Acting Chairman made the following summing up:

Executive Directors were in general agreement with the staff appraisal. Following the favorable economic results of 1986, the Swedish economy, on the whole, was expected to continue performing well in 1987, Directors noted. The real growth rate of GDP was likely to climb back to 2 percent, unemployment had dropped to below 2 percent, and the external current account was projected to be in balance during the year. But, Directors pointed out, the rate of inflation--at about 4 percent--remained above that in trading partner countries. Furthermore, as a result of the continuing deterioration in the real trade balance, the underlying weakness in the external position could reassert itself, thereby threatening the basis for maintaining Sweden's enviable record on growth and employment.

Directors emphasized the need to avoid additional external borrowing. In this regard, they noted that large wage increases in a tight labor market, especially in 1984, had contributed to a weakening of Swedish competitiveness. Rising incomes had fueled growth in private consumption, which had spilled over into rising imports. Directors welcomed the authorities' efforts to explore ways of moderating wage increases, but cautioned that wage moderation would be particularly difficult to achieve under the existing tight conditions in the labor market.

Directors supported the authorities' refusal to offset excessive wage increases by depreciating the krona. They noted that monetary policy was geared to support stable exchange rates by ensuring balance in the foreign currency flow, and generally took the view that monetary policy was appropriately tight.

Noting the considerable improvement in the public sector financial balance in recent years to an expected surplus in 1987, Directors urged the authorities to further improve the fiscal balance, thus compensating for a possible shrinkage in private savings as a result of an erosion of profits owing to wage escalation. Directors agreed that greater public restraint should focus on current outlays, including those of the local authorities. At the same time, Directors welcomed the developing consensus in Sweden on the need for far-reaching tax reform in order to improve incentives to work and save and to simplify the system. A number of Directors encouraged the authorities to accelerate the timetable for tax reform.

Directors pointed out that fiscal policy needed to be sufficiently tight to achieve wage moderation adequate to safeguard Swedish competitiveness so as to support exports and investment. A number of Directors emphasized that the authorities should set the tone by restraining wage increases in the public sector; in that regard, the proposed cash limits in the Central Government for wage cost increases were noted with interest. Directors also drew attention to the Government's willingness to trade an increase in payroll tax for an appropriately moderate wage settlement between social partners.

Directors stressed the importance of maintaining strong growth in investment and improving labor market efficiency to increase productivity and expand output. To achieve such investment, exports would have to expand more rapidly than they have in recent years, Directors warned. However, they cautioned that prospects for Swedish competitiveness could deteriorate if labor markets remained tight and demand pressures remained high.

Directors noted with satisfaction Sweden's generally open trade policy and commended Sweden for its exemplary record in foreign aid.

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

2. SUDAN - OVERDUE FINANCIAL OBLIGATIONS - REVIEW FOLLOWING DECLARATION OF INELIGIBILITY

The Executive Directors considered a staff paper on the third review of the matter of Sudan's overdue obligations to the Fund following the declaration of Sudan's ineligibility to use the general resources of the Fund with effect from February 3, 1986 (EBS/87/164, 7/27/87; and Sup. 1, 8/6/87).

The staff representative from the Middle Eastern Department made the following statement:

> As indicated in the staff paper, on July 25 a staff team initiated, in Khartoum, a review of recent economic developments in Sudan and discussed with the Sudanese authorities the formulation and implementation of economic and financial policies to address the country's economic and financial problems. As indicated on several occasions by the Managing Director to the Sudanese authorities, Fund management would be prepared to assist the Sudanese authorities in obtaining additional international economic assistance and debt relief that is crucially needed for supporting growth-oriented policies and the regularization of the country's external financial relations, including clearance of the arrears to the Fund, if consensus between the authorities and the Fund staff could be reached on the formulation and implementation of a comprehensive and far-reaching program of economic reform developed in a medium-term context. The mission has had extensive discussions, which continued until Monday. Preliminary views received from the mission as of Sunday are described below.

The sociopolitical climate in Sudan remains fragile with the continuation of the civil conflict in the South, the influx of refugees from the neighboring countries, and lack of progress in tackling the economic problems. In the circumstances, the Government recently declared a state of emergency.

Latest data confirm the continuation of the trends that are indicated in the staff paper. Despite a modest expansion in domestic production, the economy has experienced a further deterioration in its overall economic and financial conditions. This has been reflected in a worsening of the budgetary situation, rapid liquidity expansion, the intensification of inflationary pressures, and acute balance of payments difficulties resulting in further import compression, shortages of essential commodities, and an additional accumulation of external payments arrears. The budgetary weakness was manifested in government borrowing from the banking system in 1986/87 of an estimated LSd 1.5 billion, which was similar to the total borrowing of two previous years together and equivalent to over 50 percent of government budgetary revenues. The consequent impact on domestic liquidity was compounded by heavy borrowing by the public producing entities, owing to their inability to improve operational efficiency, and by trading corporations, owing essentially to financial losses reflecting the overvalued exchange rate. In addition, the Government used credit for large stockpiling of oilseeds and sorghum. As a result, domestic liquidity grew by an estimated 34 percent in 1986/87, which--superimposed on the 32 percent expansion in the previous year--has intensified underlying inflationary pressures. The deterioration in domestic financial conditions was accompanied by a further worsening of Sudan's external position. A marked reduction in foreign exchange receipts--reflecting stagnant exports, declining remittances, and lower aid disbursements--led to a fall in import levels and an accumulation of external arrears. The compression in imports was reflected not only in widespread shortages of essential consumer goods, but also in further under-utilization of industrial capacity owing to inadequate availability of imported inputs.

The present Government is keen to address the country's economic problems. There is also an agreement between the staff and the authorities on the objectives of policies and the direction of their change. Some actions have already been taken by the authorities in the areas of, inter alia, production promotion, revenue generation, expenditure control, parastatal reform, and encouragement of private sector activity. However, these have not been sufficient in scope, particularly in the absence of a comprehensive program. The staff continues to hold the view that only a comprehensive reform program, sustained on a continuous basis and supported by substantial external assistance, can begin to have a noticeable effect on the structural problems of the country.

The Acting Chairman, reviewing developments since the previous discussion on Sudan's overdue obligations on February 4, 1987 (EBM/87/21 and EBM/87/22, 2/4/87) recalled that the decision taken at that time stressed the urgent need for the authorities to adopt a strong and comprehensive economic adjustment program. In communicating that message to the authorities on February 13, the Managing Director indicated his intention to play an active role in assisting Sudan to mobilize financial resources in support of comprehensive economic policy actions. In a letter to the Sudanese Prime Minister in mid-June, the Managing Director reiterated the need to adopt policies that would enable the country to achieve sustained economic growth within the context of external and internal financial stability, as well as his willingness to take a personal initiative to help facilitate the mobilization of external assistance. In his response in early July, the Prime Minister thanked the Managing Director for his communication and indicated that the authorities were in the process of formulating an economic adjustment program. At the same time, he invited the Fund to send a staff mission in late July to provide some technical assistance in formulating that economic program. The staff visited Sudan during the period July 23-August 3 and, upon returning to Washington, reviewed the authorities' policy package with other members of the staff and with management.

The Government had provided a statement of some important policy actions that, if implemented, would be an important, decisive first step in the adjustment process, the Acting Chairman remarked. Obviously, implementing those policies over the course of the coming year, as well as building on them in the future, would be extremely important to achieve and sustain the recovery of domestic economic activity and restore internal and external balance. On the basis of the policy package, he would be calling a meeting of Executive Directors representing the major donor and creditor countries for Sudan to discuss with them the program and its financing implications, both for the short run and the longer term.

In sum, some important progress had been made, but there was still a long way to go, the Acting Chairman continued. The implementation of the Government's program would require not only action by the authorities but also, simultaneously, support from the international financial community.

The staff representative from the Middle Eastern Department remarked that the policy package covering the fiscal year 1987/88 had been worked out in the context of a medium-term strategy. The achievement of its objectives, even in the short run, was predicated on some important assumptions, including the implementation of policies in a comprehensive, timely, and uninterrupted manner, and the timely availability of required external resources.

The authorities and the staff were in agreement on supply-side policies, the staff representative continued. The authorities were committed to maintaining minimum procurement prices for certain major agricultural commodities, formulated in consultation with the World Bank, to ensure adequate incentives for production. Whereas in the past price incentives had usually been financed through credit creation, which led to problems on the demand side, the authorities' policy stance for 1987/88 aimed at ensuring no credit financing of those transfers.

The other important area for production promotion was ensuring supplies of imported inputs both for agriculture and for industry, the staff representative observed. The authorities intended to liberalize some of the regulations governing foreign exchange financing for those purposes. They were also committed to a comprehensive program of parastatal reform in collaboration with the World Bank. The aim was to rehabilitate the depleted capital stock, introduce more realistic pricing on the basis of commercial considerations, and liquidate or privatize those entities that were no longer viable. To revitalize private sector productivity, the authorities were trying to work out a policy framework that clearly defined the role of the private sector and rationalized the regulations on pricing and profits, which in the past had been a negative factor. Policies had already been implemented to dismantle protectionist policies that insulated a number of inefficient monopolies from competition.

Those production measures were being reinforced by the adoption of a realistic and flexible exchange rate policy, the staff representative commented. The authorities were committed to unifying fragmented and overvalued rates at a realistic level. They had specified both the dates and rate; in general, the level had been carefully worked out to ensure the competitiveness of all major exports and some flexibility if the cost structure changed. The exchange rate action would be passed through fully to prices, except for two basic commodities, bread and pharmaceuticals. The subsidies involved would be shown in the budget. In the petroleum sector, certain products--gas oil, fuel oil, kerosene--would also be subsidized, while the prices of benzine and super benzine would be increased to levels much higher than otherwise required. Thus, there would be a cross-subsidy in that sector, but the net effect would be a budgetary gain from petroleum sector operations.

In the staff's judgment, the authorities had made a major effort to change the direction of the budget, the staff representative remarked. Additional revenue measures were to be implemented, which, on an annual basis, would increase the revenue/GDP ratio by some 3 percent. There would also be a tight containment of expenditures, which were expected to decline by 1 percentage point in terms of GDP. Domestic bank borrowing would be reduced substantially from about 5 percent of GDP in 1986/87 to about 2 percent in 1987/88.

The measures that the authorities proposed to take to generate revenues, together with the tightening of credit to corporations and the rationalization of the private sector, would lead to a rate of money expansion of about 23 percent in 1987/88, compared with about 34 percent in 1986/87 and about 44 percent in 1987/88 in the absence of the proposed measures, the staff representative added.

In the external sector, provision had been made for a substantial increase in imports to sustain the growth rates assumed under the Program of Action, the staff representative from the Middle Eastern Department explained. At the same time, because of the lagged response of production to exchange rate changes, exports were unlikely to exceed the level projected in the absence of policy changes. There would also be a lagged effect in the following years. Covering all external debt arrears as well as the obligations falling due in 1987/88 so as to normalize debtor-creditor relations was an important element of the entire exercise. Therefore, a large amount of external financial assistance would be required.

The staff representative from the Treasurer's Department remarked that a payment of $5 million, equivalent to SDR 3.9 million, had been received from Sudan on July 29, 1987 in respect of SDR charges that had fallen due on August 1 and semiannual charges relating to the supplementary financing facility. In light of that payment and of the developments in economic policy, the situation with respect to Sudan had changed substantially since the staff paper had been issued. That change could be reflected in the proposed decision by inserting a sentence at the beginning of the second paragraph to read: "The Fund welcomes the recent payment made by Sudan." In addition, paragraph 3 might be revised to read: "The Fund notes the statement of the Acting Managing Director that the authorities are in the process of establishing and implementing a comprehensive economic adjustment program...."

Mr. El Kogali made the following statement:

> My authorities deeply regret that the Board once again has to take up the problem of Sudan's overdue obligations to the Fund. This is not a pleasant matter for them, and they would have preferred to make a timely settlement, if only that were possible. In the circumstances, I would like to reassure the Board and management of Sudan's commitment to honor its obligations to the Fund, and to stress that my authorities are fully aware of the implications for Sudan of the rising level of arrears and the impact that this has on the revolving character of the Fund's resources.
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> The problem persists because of Sudan's protracted foreign exchange crisis. Nevertheless, it can be said that Sudan has made a sincere effort to make payments to the Fund since the declaration of ineligibility was made. On July 29, an amount of $5 million was paid, despite the pressure to alleviate shortages of basic commodities resulting from the scarcity of foreign exchange. Since the beginning of this year a total of SDR 12.4 million has been paid. Although the amount is small relative to the size of the arrears, there can be no doubt that it represents a substantial effort, given the predicament of the Sudanese economy at this time.

It is well known that the new democratic Government of the Sudan inherited a plethora of problems: the continuing civil unrest in the south, the difficulties and costs associated with maintaining the sociopolitical consensus that is necessary for the survival of democratic institutions, the high influx of refugees--estimated to be 2 million, or 10 percent of the population--and a heavy debt service burden.

This is the background against which the adjustment effort has to take place. It is clear that the problem is not one of temporary imbalance; rather, it is more a reflection of deep-seated structural rigidities. Since taking office, the democratic Government has accorded the highest priority to redressing the economic problems it inherited, but the task is a very difficult one.

Recent communication from my authorities indicates that the process of reform is being strengthened. Despite considerable opposition within the country to adjustment programs worked out in consultation with the Fund, the authorities reached understandings with the staff a few days ago on both the general thrust as well as the specific details of what should constitute the beginning of a comprehensive economic and financial program. The consultation with the staff reflects the Government's intention to continue its close relationship with the Fund in seeking solutions to its economic problems.

Virtually all areas of the economy have been touched by this policy package with a view to enhancing supply while restraining demand. An important part of this effort is the decision to implement a flexible exchange rate policy and unify exchange rates at a level consistent with the need to strengthen production and export incentives. This aspect of the program, in particular, demonstrates the authorities' resolve to take socially and politically difficult decisions. It is well known that the exchange rate question is a sensitive topic in Sudan, and has been a rallying point for those who have been opposed to the Fund.

Action on the exchange rate is expected to be supported with appropriate fiscal and monetary policies. Accordingly, measures will be taken to improve revenue performance, contain the growth in expenditure, and limit the overall growth in domestic liquidity. Steps are also being taken to reform the banking system to ensure that the rate of return reflects the rate of inflation and normal bank charges, to promote private sector investment, and to ensure the payment of remunerative producer prices.

Although these efforts together constitute a strong program, or at least a good start, realistically they cannot be expected to solve Sudan's foreign exchange problem immediately. In fact, it is projected that the expansion in the country's net foreign exchange position will be limited in 1987/88. This is not surprising, since it will take time for the policies to bear fruit. Substantial additional support from the international community will be needed in the form of debt forgiveness, debt relief, commodity aid and cash, on highly concessional terms. Such assistance will enable the authorities to provide essential consumer goods, adequate supplies of which are necessary to ensure domestic support for the tough measures that are being envisaged, as well as critical inputs for the productive sector. It is important that adequate external support be provided at the early stage of the program in order to have timely support for the Government's initiatives. My authorities would like to discuss this matter with the donor community at the earliest possible time.

My authorities would also like to stress the need for additional concessional resources to help them settle the problem of external arrears, especially arrears to the Fund. In this connection, they are prepared to work with donor countries to arrive at an acceptable financial arrangement that would help them become current with the Fund.

The authorities have reason to believe that they can succeed. Sudan has substantial potential for increased agricultural production, and already producers are beginning to respond to incentives being offered by the Government. Possibilities also exist to expand the herd of livestock and to augment the export of livestock and associated products through official channels. The rural sector, with its tradition of thriftiness, is a potential source for mobilizing resources for productive investment. Meanwhile, it is hoped that exchange rate incentives will help to attract remittances from the large number of Sudanese, professionals and others, working abroad.

The authorities' new policy package represents a major first step toward placing the economy on the path of sustained growth and balance of payments viability. We hope that the international community will meet us halfway in this endeavor.

Mr. Nimatallah remarked that Sudan, having resolved its political problems and having returned to democracy, seemed ready to undertake serious and far-reaching economic policy actions, and he welcomed that positive development. Sudan's recent payment of SDR 4 million was also encouraging, particularly in view of the Board's appeal to members to pay at least the charges due on their arrears and thereby reduce the burden of overdue obligations on the membership. That payment showed the authorities' commendable attitude.

The comprehensive adjustment program outlined by the staff indicated the authorities' intention to improve the economy's performance and eventually enable Sudan to repay the Fund, Mr. Nimatallah added. It was also encouraging that management considered the program to be a positive first step. He hoped that it would lead to even further far-reaching measures to continue the process of adjustment until Sudan attained its economic potential.

He supported the draft decision, as amended by the staff, Mr. Nimatallah concluded. He also wished to convey to the authorities, through Mr. El Kogali, a message that the Board appreciated their positive attitude and urged them to persevere in their efforts.

Mr. Foot remarked that Mr. Nimatallah had covered most of the points he wanted to make. The news reported by the staff was welcome, and the proposed decision, as amended by the staff, was entirely appropriate. Clearly, the spirit of the message that the Board ought to send to the authorities should be even more encouraging; it was important to recognize the courageous step they had taken in difficult circumstances.

His chair would be pleased to pursue the subject of financing the program as soon as the staff analysis of the program was completed, Mr. Foot commented. In that regard, he urged that as much detail as possible should be provided; it would be impossible to evaluate both the feasibility of the program and the financing requirements unless donors fully understood the assumptions on which they were based. Such details at the outset would help avoid delays and thus facilitate the assembling of financing.

Mr. Finaish made the following statement:

> We warmly welcome the Acting Chairman's statement and the encouraging report by the staff on its recent discussions with the Sudanese authorities. We also welcome Mr. El Kogali's constructive statement, which confirms the authorities' readiness to begin the difficult process of bringing Sudan out of the economic morass it has been in in recent years. The payment by Sudan of $5 million, although small relative to total arrears, given Sudan's situation, represents a strong indication of the authorities' eagerness to normalize Sudan's relations with the Fund.
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> The economic and financial problems facing Sudan are so difficult that one can express optimism only with some hesitation. Nevertheless, from what we know and from what we heard today from the staff and Mr. El Kogali, I believe that there is indeed a reason for optimism. The economic program that the authorities have discussed with the staff appears to be quite comprehensive, with clearly specified measures to address the various financial and structural imbalances in the economy.
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> We are impressed by the strong fiscal adjustment contained in the program, particularly on the revenue side, and the plan for exchange rate reform, including the unification of rates. The

latter can play a crucial role in encouraging remittances and investment flows from expatriate workers, a point that was especially emphasized during the discussion of the 1986 Article IV consultation with Sudan last February. We have also noted the wide range of measures to promote private sector activity, including price and profit liberalization, and institutional reform of the banking sector. These actions, together with the clear plan for reforming the public enterprise sector, provide a clear indication that the authorities are ready to tackle the difficult, deep-seated structural imbalances which had impeded the efficiency and growth of the economy for so long.

During our discussion in February, I had emphasized that for any adjustment program in Sudan to succeed in dealing with the financial imbalances and at the same time stimulate investment and productive activity, it had to provide for an adequate level of imports. I am therefore pleased that the authorities' economic program provides for a reasonable degree of import recovery.

While the adoption of a strong, credible adjustment program has always been considered a prerequisite for any viable solution for Sudan's payments problems, it is difficult to overstate the enormity of the task that lies ahead. With arrears to the Fund alone exceeding total export receipts by a wide margin, and with so many exogenous factors--including a massive refugee problem and continued turmoil in the South--the workability of the adjustment program will require an exceptional, determined effort on the part of the international community in support of Sudan. Clearly the program covers a number of sensitive areas, such as the prices of necessities. It is difficult to see how such sensitive measures could be implemented without adequate and timely financial support, in view of the current sociopolitical climate in Sudan.

The Fund will have an instrumental role to play in this collaborative effort. The task of solving Sudan's problems is enormous, but the stakes for the Fund are just as great. Such a solution will not only help the Fund recover large amounts of resources owed to it by Sudan, but will also demonstrate that even the most difficult case of overdue obligations can be dealt with and eventually resolved, if the member is willing to cooperate with the Fund in finding such a solution. I believe the implications of that message will not be lost on other members in arrears to the Fund.

In conclusion, we can support the proposed decision, with the suggested amendments.

Mr. Dallara remarked that he welcomed Sudan's payment, which clearly indicated the authorities' desire to normalize their financial relations with the Fund. The staff and the authorities had agreed at various times in the past on the broad objectives of economic policy but had been unable to reach agreement on specific policies to achieve those objectives. The authorities' program was therefore especially welcome as an important and decisive first step in the process of adjusting Sudan's economy and restoring it to a stable growth path.

His authorities wished to reiterate their willingness to participate in a multilateral effort to support Sudan in eliminating its arrears to the Fund and normalizing its external financial position, once a satisfactory program had been developed and was in place, Mr. Dallara continued. In view of the daunting size of Sudan's external arrears problem, the efforts of donors and creditors would need to be broadly based and genuinely multilateral in nature. To enable all parties to focus on that problem and to respond constructively, it was important to make available as soon as feasible to donors and creditors a comprehensive presentation of the policies that were emerging and a considered analysis of how those policies could address the imbalances in the economy. The authorities should also take decisive early steps that could serve as important signals, not only to economic agents in Sudan but to donors and creditors, that the economic environment was changing. Close cooperation with the World Bank in those efforts was also important, and he looked forward to hearing about the Bank's plans in support of Sudan's program in the near future.

The suggested amendments to the draft decision seemed appropriate under the circumstances, Mr. Dallara commented. However, to help maintain the momentum that the authorities had created, the Board might wish to review the matter again in, say, three months, which would give the authorities time to more clearly articulate and begin the process of implementing their program and would give the staff and creditors time to assess the possibilities for their own action.

Mr. Sengupta remarked that he welcomed the recent turn of events and commended the authorities for taking major, courageous steps in working out the basic elements of a policy program. His chair had consistently maintained that the problem of overdue obligations had to be tackled on a case-by-case basis that provided for a program designed to meet the specific challenges facing the member. In Sudan's case, the Managing Director had indicated that if the Government was prepared to come forward with a program, then the international community would make every effort to support its program. The Sudanese authorities had fulfilled their part of the obligation. The major role that creditors would play had yet to be seen. Sudan's debt service obligation amounted to about $4.7 billion. A detailed breakdown of the amount owed to each creditor would be helpful in apportioning the creditors' responsibility for the adjustment effort.

He encouraged the Sudanese Government to maintain the momentum that had been gained and urged an early response by creditors to the authorities' efforts, Mr. Sengupta added. If that could be achieved, it might be possible to break the back of the general problem of overdue obligations to the Fund.

Mr. Grosche remarked that he also welcomed the good news that the Sudanese authorities were about to take a first big step on a very steep road toward adjustment and thereby to higher growth. He agreed with the proposed decision and understood from paragraph 3, as amended, that management considered that the program would provide the basis for expanded external assistance. Like Mr. Foot and Mr. Dallara, he would urge the staff to provide Directors with precise details on the program insofar as was possible, particularly with regard to the early steps that were being considered, to enable them to make a solid judgment on the program's viability. Otherwise, it would be almost impossible for donors and creditors to reach agreement on the assistance required.

Mr. Mawakani stated that he welcomed the statements by the Acting Chairman, the staff, and Mr. El Kogali. He fully supported the comments made by Mr. Nimatallah, and he also supported the proposed decision, as amended by the staff.

Mr. Tamami observed that because of the structural problems of the Sudanese economy, the issue of overdue obligations could not be resolved in a short period of time. Consecutive years of severe drought and devastating famine between 1982 and 1985, the entry into Sudan of more than 1 million refugees, and population movements to urban areas were among the factors overburdening an already mismanaged economy. The present Government faced formidable and challenging problems. External arrears had rapidly accumulated as debt service obligations had not been met. Compounding external debt was the most pressing factor in Sudan's economy at the present time.

No adjustment effort would bear fruit without sufficient external financing, Mr. Tamami considered. For Sudan, debt relief as well as concessional financing was an absolute necessity and should be considered as an integral part of the adjustment program.

His chair had consistently maintained that countries with overdue obligations should do their utmost to discharge those obligations and to clear any arrears vis-à-vis all creditors in a nondiscriminatory manner, Mr. Tamami commented. He was therefore pleased to note the intention of the new Government to clear its arrears. In this regard, he welcomed the authorities' effort to become and remain current in the SDR Department as well as the partial payment to the Fund. That development could be attributed to the maintenance of an active policy dialogue between the authorities and the Fund. The Fund's effort to continue a positive dialogue with the authorities, the donors, and the international financial community to help the country achieve its stated objectives was also welcome. He endorsed the proposed decision, as amended.

Mr. Ortiz remarked that he welcomed Sudan's payment to the Fund. He fully appreciated the magnitude of the effort that the authorities were undertaking to address deep-seated problems in their economy, and he therefore supported the proposed modification to the draft decision, which conveyed a positive message to the authorities. Finally, he wished to associate himself with Mr. Sengupta's comments on the general problem of overdue obligations.

Mr. Hospedales commented that he was gratified to hear that Sudan was formulating a comprehensive adjustment program and had taken a number of important policy actions, including the payment of SDR 12.4 million since the beginning of the year, of which a payment of SDR 3.9 million had been made only recently. Those actions were a clear expression of the authorities' intention to honor their obligations to the Fund and to restore their historically close relationship with the institution.

The Fund had given the correct signals to the authorities, who were responding accordingly, Mr. Hospedales considered. His chair had always insisted on continuing persuasion and policy dialogue with countries in arrears to the Fund as essential to the strategy for resolving the problem of overdue obligations. The Fund should continue to facilitate those initiatives and consolidate the progress made so far. The result would undoubtedly be the adoption of a comprehensive adjustment program in Sudan with international financial support, thereby ensuring the liquidation of arrears and the achievement of medium-term economic and financial stability, which was the main objective of the Fund and Sudan. Finally, he could support the proposed decision, as amended.

Mr. Sugita stated that he welcomed the initiative by the Sudanese authorities to tackle their economic and financial problems as well as the partial payment to the Fund. The problems facing Sudan were structural and deep-rooted, and the measures announced by the authorities represented only a first step toward solving those difficult problems. Timely and comprehensive implementation of the authorities' program would need to be followed by sustained efforts. He could support the proposed decision, as amended by the staff and by Mr. Dallara.

Mr. Massé remarked that recent developments in Sudan were encouraging. Like Mr. Sengupta, he would stress that the congratulations offered were for the authorities' courage to embark on an obviously difficult path. The authorities' commitment would have to be supported by contributions by the various donor countries, and it was perhaps time for the major donors to agree that their contributions had to be increased, whether for specific countries or through the enhancement of the structural adjustment facility. The meeting of major donors for Sudan might discuss that general point because requests for financing were becoming more and more frequent. He agreed with other speakers that full details of the various policies would be needed to convince donors and creditors that the proposed program would result in a comprehensive economic management plan for Sudan.

Mr. Posthumus recalled that during the discussion on Sudan in February, he had urged the authorities to follow the staff's recommendations and had expressed his confidence that if they did so, the international community would then continue to assist Sudan in solving its huge problems. He still believed that that was true. In general, he associated himself with the comments made by Mr. Dallara and Mr. Sengupta.

Mr. Lim stated that he was encouraged by the sincere efforts of the Sudanese authorities to normalize their relations with the Fund. He supported the draft decision, as amended.

Mr. Manfredi Selvaggi remarked that he welcomed the measures announced by the authorities and the partial payment of arrears to the Fund. He therefore supported the proposed decision, as amended. He urged the staff and the authorities to provide further information on the program as soon as possible.

Mr. Sengupta commented that he was inclined to support Mr. Dallara's amendment. However, he wondered whether, in view of some speakers' call for details concerning the program as well as its financing requirements, it would be possible to fulfill those requests and to meet with donors and creditors within three months' time. If so, he could support Mr. Dallara's request.

The staff representative from the Middle Eastern Department responded that most of the policy actions that the Sudanese authorities were willing to take had to be implemented by October 1. Most of the staff's calculations had been based on that deadline. Thus, in three months' time, the staff would be in a position to evaluate and report to the Board on whether the policies were in place and on the implications of those policies for financing.

The Acting Chairman remarked that management had no problem with a review within three months' time to enable the Board to assess the status of the program and of external financing.

Mr. El Kogali remarked that he agreed on the need to maintain the momentum of the authorities' efforts and to encourage urgent action by the international community. He therefore had no difficulty with reviewing the decision within three months.

Mr. Ovi remarked that his chair strongly welcomed the initiative of the Sudanese authorities. His chair had consistently emphasized the need for a comprehensive program for economic adjustment. In addition, he had stressed that increased financial flows on concessional terms from donor countries would be necessary to support economic reforms. He hoped that rapid progress would materialize in both areas in the very near future. Accordingly, he could support the decision, as amended by the staff and by Mr. Dallara.

Mr. Pineau remarked that his authorities were favorably impressed by the recent steps taken by the Sudanese authorities, but at the same time, they would be interested in further information on the precise measures and objectives to be included in the comprehensive program. He could go along with the proposed decision, as amended.

The Secretary remarked that with regard to paragraph 4 of the decision, he understood that the change of the review period from six to three months was being made on an ad hoc basis in the case of Sudan and that the procedural rule that decisions in respect of a declaration of ineligibility owing to overdue obligations would be subject to review every six months remained unchanged.

Following a further brief discussion, Directors agreed that in view of the urgency of the present case, they would review the matter of Sudan's overdue obligations within three months.

The Executive Board then took the following decision:

1. The Fund has reviewed further the matter of Sudan's continuing failure to fulfill its financial obligations to the Fund in light of the facts and developments described in EBS/87/164 (7/27/87) and Supplement 1 (8/6/87).

2. The Fund welcomes the recent payment made by Sudan. However, the Fund deeply regrets the continuing failure of Sudan to fulfill its financial obligations to the Fund and again urges Sudan to make full and prompt settlement of those obligations.

3. The Fund notes the statement of the Acting Managing Director that the authorities are in the process of establishing and implementing a comprehensive economic adjustment program, which would provide the basis for expanded external financial support from donors and creditors.

4. The Fund will review the matter of Sudan's overdue financial obligations to the Fund again within three months of the date of this decision.

Decision No. 8678-(87/121), adopted
August 7, 1987

3. OFFICE SPACE - JOINT LIBRARY

The Executive Directors discussed the proposed transfer of the Joint Library to the International Square Building (EBAP/87/173, 8/4/87).

Mr. Sengupta remarked that easy access to the Joint Library at all times was essential to the proper functioning of his office and the Fund staff. He therefore preferred that the Library remain where it was. At the same time, he was interested in the orderly functioning of the Fund as a whole. For that reason, he thought that the proposal to relocate the Library and the administrative problems such a decision might entail should be brought to the Board for discussion.

Mr. Kafka remarked that his request that the proposal to transfer the Library be brought to the Board for discussion had been motivated by the same concerns expressed by Mr. Sengupta. The Board should, if it so wished, have a helpful, timely input into any decision on the Library. While he had an open mind on the question, some additional information would be helpful. For example, what were the relative advantages of moving the Library and the best alternative--say, moving the Bureau of Computer Services? His own research indicated that about 50 or 60 persons used the Library on a daily basis; how did that figure compare with daily contacts between the Bureau of Computer Services and the rest of the staff?

The concept of library user was not clear to him, Mr. Kafka continued. Apparently the user figure was based on an informal estimate arrived at by counting, at various times of day, the number of readers in the Library. But there were also other types of users. For instance, materials requested by phone might be picked up by a secretary; the secretary was not considered a user, but the caller was also not included in the daily tally. He was concerned that if the Library were moved to International Square, the receipt of materials requested by phone would be delayed.

Moving the Bureau of Computer Services might entail less inconvenience, Mr. Kafka commented. Contacts between the Bureau and the rest of the staff could take place by telephone, and a vehicle might be put at the disposal of the Bureau to facilitate the movement of personnel between International Square and Fund headquarters.

Mr. Nimatallah considered that the main concern was to minimize the inconvenience associated with locating a unit outside Fund headquarters. If moving the Library inconvenienced more people than moving, for example, the Bureau of Computer Services, then he would prefer to see the Library remain where it was.

Mr. Prader commented that the proposal to move the Library was cause for concern. The kind of arrangement envisaged by the Administration Department to compensate for the relocation of the Library could never satisfy active library users. If there was no immediate, direct access to the Library, library use would decline drastically. Relocating the Library rather than the Bureau of Computer Services also signified some preferences: the Fund, which had one of the best financial libraries in the world, would be giving the signal that it did not care about the Library. Mr. Kafka's suggestion to move the Bureau of Computer Services was in line with the relocation of the Bureau of Statistics in International Square and would be preferable under the circumstances.

Mr. Tamami remarked that he wished to associate himself with the comments made by Mr. Sengupta and Mr. Kafka. More specifically, the memorandum on the proposed transfer did not include an analysis of other alternatives, making it difficult to assess management's proposal. The two guiding principles outlined in the memorandum were appropriate.

However, another principle--the need to minimize the costs of such a transfer--should also be taken into consideration. In particular, attention should be focused on the related costs of additional contractual employees to staff the reference center and the special messenger service, as well as the costs associated with extending the Library's hours of operation.

His constituency was among the frequent users of the Joint Library, and its transfer to International Square would be highly inconvenient, Mr. Tamami commented. Taking into account that fact and the other concerns he had raised, he proposed that the analysis undertaken by the Administration Department, including other options, should be submitted to the Executive Board for further consideration before a decision was taken.

Mr. Templeman remarked that the alternatives to relocating the Joint Library had not been clearly spelled out. He wondered what other units besides the Bureau of Computer Services might be considered for relocation.

The Deputy Director of Administration remarked that two criteria had been applied in selecting a unit for transfer to the International Square Building: minimizing the disruption and inconvenience for the Fund as a whole; and achieving the best use of space, both at International Square as well as at headquarters. By virtue of the first criterion, units having heavy interaction with the Board, management, and other units of the staff--the area departments, the Exchange and Trade Relations, Fiscal Affairs, and Legal Departments--as well as large sections of other departments--the Administration Department, the Treasurer's Department, and the Secretary's Department--were excluded.

The second criterion had posed some problems, the Deputy Director commented. First, there was a premium on moving a complete unit. The ideal unit would be one large enough to fill the 55,000 square feet of available space at International Square.

By contrast, splitting up units could entail a duplication of office space at headquarters for conducting business with units remaining there. The appropriate use of space was another consideration. For example, although the Institute was an ideal unit in terms of size, the space at International Square did not meet its requirements for column-free lecture rooms. Moreover, the space eventually freed up at headquarters should be suitable for housing expanding departments. That consideration precluded the relocation of the Computer Center. In fact, the Fund's mainframe computer activities, at present located on the Concourse level and in rented space on MacArthur Boulevard, were being consolidated into one unit on the Concourse level. Moving other units, such as parts of the External Relations Department, would free up space on the 12th floor, but the use of space on that floor, as well as on the 11th and 13th floors, was restricted for security reasons.

Applying those criteria, three alternatives emerged--relocating the Bureau of Computer Services, the Joint Library, or a combination of selected units from two or three departments, the Deputy Director explained The mixed solution had been eliminated because of the disruption factor and because it had been felt that that option should be retained for the future when more staff might have to be relocated outside headquarters.

The Bureau of Computing Services was too large to be moved as a unit, the Deputy Director observed. The space at International Square could accommodate 125 staff members; the Bureau had 251 staff members--75 regular staff plus contractual staff. The Bureau was organized into four divisions and an immediate office. The largest division, the Operations Division, ran the Computer Center, the peripheral equipment, and the tape libraries. Since the staff servicing the mainframe computers would have to stay with the equipment, the relocation of two development divisions--accounting for some 82 staff--had been considered. Those 82 persons could be separated about equally into analysts and programmers. Typically, analysts spent most of their time with the client/user. Moving those two divisions to International Square meant that some 40 persons would have to commute constantly between International Square and headquarters in order to assist users. Analysts also worked in close contact with their counterparts, the programmers. The remaining unit, the User Support Division, with more than 60 persons, was similar to the two development divisions in that a large part of its staff worked with the users in their departments.

As for the interactions between the Bureau and the rest of the Fund, the Bureau worked, on average, on 300 different development and production projects throughout the Fund, the Deputy Director continued. Meetings of Bureau staff with the rest of the Fund represented 32,000 man-meetings per year; and meetings between analysts and programmers within the Bureau represented 23,000 man-meetings per year. Consequently, the interaction of Bureau staff with staff at headquarters had serious implications for the Bureau's work and in terms of supervision, especially over contractual employees. The ratio between supervisory personnel and Bureau staff was already low at one supervisor for 27 staff--the Fund average was 1 to 9--and would be stretched even thinner if part of the Bureau was relocated. Some duplication of space--about 5,000 square feet--would also be required, which would reduce the amount of space freed up by the relocation of the unit.

By contrast, the Joint Library was an ideal unit in terms of size, the Deputy Director commented. The space available at International Square exceeded its space requirements somewhat, leaving some flexibility for future space management. Considerably fewer staff--some 60 persons--would be affected. About 20,000 square feet of prime space, which could house 100 staff would be freed up at headquarters; only 10,000 square feet would be freed by relocating part of the Bureau. Relocating the Joint Library would also reduce considerably the need for duplicate space. A reference center and reading room would have to be established at headquarters, which would require about 1,000 square feet. By moving the records kept at the Concourse level to space deeper in the building, additional space would become available on that level for offices. The serious overcrowding in the Joint Library would also be relieved through relocation. Finally, moving the Library would relieve pressure exactly at those points where there was a need for expansion; for instance, in the Communications Division and the Bureau's mainframe computer operations personnel.

According to the available statistics on library use, of 50 daily users, 30 were Bank personnel--who would not be affected by the move--and 5 were outsiders, which left 15 Fund users on an average day, the Deputy Director noted. Under the proposed plan, the most widely read publications would be available in the Reference Center to be established at headquarters. In addition, data base computer searches could be conducted and abstract printouts could be obtained through the Office Automation System that was being extended to Executive Directors' offices. Using the regular messenger service for delivery of library materials requested by phone should not extend the time required for filing requests. Indeed, with the augmented messenger system dedicated to deliveries to and from the Library, that service should be improved.

Other departments of the Fund had been asked for their views on the possible alternatives, and, on balance, they agreed that the transfer of the Library would minimize the disruption and inconvenience to the staff, the Deputy Director added. Moreover, the Library represented a weak point in building security because the movements of non-Fund users in the building were not monitored. Transfer of the Library would also solve an urgent problem related to the Publications Unit, which had to vacate its space every time the Interim and Development Committee meetings took place to make room for the press. The additional space freed up on the Concourse level would allow the Publications Unit to be moved to a permanent location.

For the first year, the total cost of the transfer, excluding recurring costs, would be $2.6 million for the Bureau, compared with $2.4 million for the Joint Library, the Deputy Director of Administration remarked. The difference--less than 10 percent--was not large. The recurring costs would be about $700,000 for the Bureau and only $200,000 for the Joint Library, which meant a savings of $0.5 million a year if the Library were moved. The one-time costs were covered by the budget in the capital account; the recurrent costs had not yet been taken into account in the budget.

Mr. Grosche remarked that it was inconvenient to have units of the Fund relocated a few blocks away. He wondered why the Fund had the responsibility for housing the Joint Library; had any thought been given to using one of the World Bank's new buildings for housing the Library?

The Deputy Director of Administration responded that under the cost-sharing agreement with the Bank, the Bank paid the larger part of the cost of Joint Library operations. The sharing agreement was reviewed periodically on the basis of user statistics. The Bank had, at one time, housed the Library on G Street, but at present the Fund was responsible for the Library, just as the Bank was responsible for the Medical Department. The Bank also had large library operations on its own premises, the Satellite Libraries, which were administered by the Fund but fully staffed by Bank personnel under the jurisdiction of the Joint Library. Those specialized libraries were intended to meet the technical needs of the Bank. At present the Bank had no contiguous space to offer for housing the Joint Library.

Mr. Comotto remarked that although the statistics on library use left much to be desired, the weight of evidence clearly favored the proposal to relocate the Library. If adequate provision was made for a reference unit at headquarters and for liaison between the headquarters and International Square, then the staff plan seemed acceptable. He could therefore support the proposed transfer.

More generally, the problem was one of unfettered expansion, Mr. Comotto suggested. He considered that within broad parameter, management should be left to manage; an in-depth examination of every management decision could lead to an increase in the manpower requirements of the Administration Department.

Mr. Templeman commented that it was evident that considerable thought had been given to all possible alternatives. He was also persuaded that every consideration had been given to minimizing the disruption of the Fund's activities. The measures suggested by the staff for alleviating the inconveniences entailed by a transfer of the Library should be adopted.

Mr. Kafka remarked that although he was not totally convinced by the staff's arguments, he considered that at present, management's attention must concentrate on providing adequate facilities at headquarters to minimize the inconvenience to users owing to the transfer of the Library. He doubted whether the proposed space--some 1,000 square feet--for the reference and satellite reading room would be sufficient. The delivery time anticipated for requested materials was also debatable; even if library hours were extended, messenger service would end at the close of business. The messenger service should be enhanced to ensure timely delivery, perhaps even after the close of business. He looked forward to learning about the specific measures that would be taken to improve delivery services for the Library.

The Director of Administration commented that his staff was looking carefully into the issues that Mr. Kafka had raised. The library staff would be discussing with various user groups the needs and interests that should be taken into account in the new arrangements. Every effort would be made to minimize the inconvenience caused by the transfer of the Library to International Square.

The Acting Chairman noted that experience with the new arrangements would be reviewed by management after the relocation had been in effect for some time.

The Executive Directors concluded their discussion on the transfer of the Joint Library to International Square.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/87/120 (8/7/87) and EBM/87/121 (8/7/87).

4. MANAGING DIRECTOR - PORTRAIT

The Executive Board approves the purchase of a portrait of former Managing Director, Mr. Jacques de Larosière, as set forth in EBAP/87/172 (8/4/87).

Adopted August 7, 1987

APPROVED: March 18, 1988

LEO VAN HOUTVEN
Secretary