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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 87/101

10:00 a.m., July 10, 1987

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	P. E. Archibong, Temporary
Dai Q.	
	D. C. Templeman, Temporary
J. de Groote	J. Prader
A. Donoso	E. Feldman
	M. Hepp, Temporary
	A. M. Othman
G. Grosche	B. Goos
J. E. Ismael	J. Reddy
A. Kafka	
T. P. Lankester	S. King, Temporary
M. Massé	D. McCormack
	N. Toé, Temporary
	I. A. Al-Assaf
	L. P. Ebrill, Temporary
G. Ortiz	
J. Ovi	M. Fogelholm
H. Ploix	S. de Forges
	G. Schurr, Temporary
	H. van der Burg, Temporary
C. R. Rye	
G. Salehkhou	O. Kabbaj
A. K. Sengupta	L. E. N. Fernando
K. Yamazaki	
S. Zecchini	N. Kyriazidis

L. Van Houtven, Secretary and Counsellor
B. J. Owen, Assistant
R. Gaster, Assistant
M. Primorac, Assistant

Also Present

IBRD: C. Jones-Carroll, Latin America and the Caribbean Regional Office. African Department: J. G. Keyes. European Department: B. Rose, Deputy Director; A. L. Bovenberg, M. T. Hadjimichael, S. M. Thakur, H. Vittas. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; C. Atkinson, E. Brau. External Relations Department: J. E. McEuen. Fiscal Affairs Department: E. S. Kreis. Legal Department: F. P. Gianviti, Director; H. Elizalde, A. O. Liuksila, R. H. Munzberg, J. K. Oh. Research Department: R. R. Rhomberg, Deputy Director; L. Alexander, D. A. De Rosa, P. Isard, N. M. Kaibni. Secretary's Department: C. Brachet, Deputy Secretary; A. P. Bhagwat. Treasurer's Department: G. F. Laske, Treasurer; T. Leddy, Deputy Treasurer; D. Williams, Deputy Treasurer; P. B. Clark, S. I. Fawzi, R. W. Furstenberg, O. Roncesvalles, P. S. Ross. Western Hemisphere Department: S. T. Beza, Director; M. Caiola, Deputy Director; D. N. Lachman, B. C. Stuart. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: E. Ayales, A. Bertuch-Samuels, G. D. Hodgson, A. R. Ismael, G. Pineau, I. Puro, I. Sliper, A Vasudevan, J. E. Zeas. Assistants to Executive Directors: M. Arif, R. Comotto, F. Di Mauro, E. C. Demaestri, W. N. Engert, S. K. Fayyad, S. Guribye, M. A. Hammoudi, G. K. Hodges, M. A. Kyhlberg, V. K. Malhotra, R. Manfredi Selvaggi, T. Morita, D. V. Nhien, C. Noriega, L. M. Piantini, S. Rebecchini, S. Rouai, G. Seyler, B. Tamami, Wang X., D. A. Woodward.

1. ARGENTINA - PURCHASE TRANSACTION - COMPENSATORY FINANCING FACILITY

The Executive Directors considered a staff paper on a request from Argentina for a purchase in an amount equivalent to SDR 518.765 million under the decision on compensatory financing of export fluctuations (EBS/87/17, 1/29/87; Sup. 3, 7/7/87; and Sup. 4, 7/9/87).

Mr. Feldman recalled that his Argentine authorities had previously requested a compensatory financing purchase of SDR 388.7 million, representing the maximum amount available under the access limit of 83 percent of quota at the time of the request, for an export shortfall for the year ended September 1986 estimated at approximately SDR 732 million. The Executive Board had approved the request in principle at EBM/87/29 (2/18/87) and EBM/87/33 (2/26/87), but the transaction was not to be carried out until the stand-by arrangement that had been requested simultaneously by Argentina became effective. A letter from the Argentine authorities setting out their revised economic program under the stand-by arrangement, which was approved in principle on February 18, 1987, had been circulated to the Executive Board for consideration on July 23, 1987 (EBS/87/155, 7/8/87). Thus, by that time, Argentina would have complied with the test of cooperation under the compensatory financing facility.

The liquidity problem faced by Argentina toward the end of February had led the authorities to request bridge financing from a group of industrial nations in the amount of $500 million, the plan being to repay it with use of the resources of the compensatory financing facility, Mr. Feldman added. Developments since that time would be discussed by the Board when it considered the revised program, and he would concentrate his remarks on the facts related to the compensatory financing purchase transaction.

First of all, various exogenous factors had affected the export performance of Argentina, Mr. Feldman observed. Export volume for 1987 had been adversely affected by rainfall and severe flooding at the end of March and in early April in the main crop growing areas and the second largest oil producing region. Export unit values had dropped by more than 20 percent during 1986 and were expected to fall a further 14 percent during 1987. For 1988, a slight increase in export prices, combined with a large increase in export volume, could be expected.

Second, since February 1987, Argentina had made two repurchases of SDR 65 million each of drawings made under the compensatory financing facility in 1984, thereby enabling the proposed purchase to be increased by SDR 130 million to SDR 518 million, while remaining within the limit of 83 percent of quota, Mr. Feldman commented.

Third, by shifting three months of the shortfall year from the year ending in September 1986 to the year ending in December 1986, the export shortfall was increased to SDR 865 million, Mr. Feldman noted. Thus, the gap between the requested purchase and the export shortfall remained significant.

As for the test of cooperation, Mr. Feldman remarked that his authorities had been negotiating actively with Fund management and staff on the formulation of economic policies to set the program back on track, in the acknowledgment that some of the stated policy objectives for the first half of 1987 had not been met, Mr. Feldman said. Since May, corrective measures had been taken and would continue to be taken in the weeks ahead.

As he had already mentioned, his authorities had prepared a letter on economic policy, which had been circulated to Executive Directors, restating the Government's renewed commitment to an economic policy that would lead the country toward a path of growth and low inflation, Mr. Feldman concluded. Thus, they felt that the test of cooperation had been duly met. On that basis, he asked the Executive Board to support the proposed decision and looked forward to a satisfactory outcome of the discussion of the economic program as a whole as scheduled on July 23.

The Acting Chairman informed Executive Directors that the Fund had received a notification overnight from the commercial bank Advisory Committee that, as of July 9, 1987, positive responses had been received for approximately 99 percent of the 1987 financing package for Argentina. The response had thus been full and relatively quick.

Mr. Kafka stated that Argentina's request was essentially straightforward. The purchase transaction had been approved in principle on February 26, 1987 in the maximum amount then available under the access limit. The decision in principle had determined that the purchase should become effective "in any event, not later than July 15, 1987 provided that Argentina continues to cooperate with the Fund." As a result, the effectiveness of the transaction was made dependent on the coming into effect of the stand-by arrangement, which had also been approved in principle on February 18, 1987. In actual fact, Argentina not only had continued to cooperate with the Fund but had formulated a revised program, to be discussed by the Executive Board within two weeks, and had obtained the bank financing which had delayed the coming into effect of the stand-by arrangement in support of the original program. The cooperation condition for a drawing under the compensatory financing facility had thus been overfulfilled. As noted in the staff paper, there was no question at all about the other conditions for a compensatory financing drawing having been met. He fully supported Argentina's request.

He took the occasion to express his hope that the Executive Board would soon review and modify the cooperation requirement for compensatory financing purchases, Mr. Kafka concluded. In effect, that requirement quite improperly and unwisely subjected drawings under the compensatory financing facility to upper credit tranche conditionality.

Mr. Ortiz observed that Argentina's request for a drawing under the compensatory financing facility had been approved in principle based on an appraisal of the balance of payments performance and projections that had unfortunately been rendered somewhat optimistic by more recent information, particularly by natural causes affecting output, as Mr. Feldman

had stated. In addition, a further decline in the volume of exports had affected the overall fiscal and financial situation. Despite the increased debt service burden, the Government had continued to make payments on schedule to both commercial and official creditors, including the Fund. Some of those payments to the Fund had increased the member's access under the compensatory financing facility. The Board had been notified that it would have the opportunity to discuss a revision of Argentina's economic program within two weeks. The letter on economic policy that had been circulated clearly indicated the authorities' commitment to continue their adjustment effort and to continue cooperating with the Fund.

In conclusion, Mr. Ortiz said that he associated himself with Mr. Kafka's comments on the test of cooperation, in line with the position taken on previous occasions by his chair.

Mr. Templeman said that when the Executive Board took its revised decision on Argentina's request for a compensatory financing purchase on February 26, his authorities had hoped that the transaction would have been carried out somewhat sooner. While there had been some slippage in securing foreign financing promptly and in the economic program, bringing the July 15 deadline for the implementation of the decision into play, he believed that sufficient assurances were available for the Board to give its final approval of the purchase transaction.

First, the critical mass of commercial bank financing for 1987 had been achieved, evidencing the cooperative spirit of the banking community, Mr. Templeman continued. Second, although the economic program had not unfolded as planned, the Argentine authorities had transmitted a new letter of intent to the Fund describing the revised program, which had been endorsed by Fund management. It would be necessary for the Board to examine the documentation more carefully before reaching a final view on the revised program at the meeting planned for July 23, but he believed that the evidence was sufficient to conclude that the test of cooperation for use of the resources of the compensatory financing facility had been adequately met. He could also support the proposed augmentation of the purchase, in line with the increased amount permitted, under the policy on access to the facility, as a result of the intervening repurchases.

However, he had a few comments and questions on certain aspects of the request by Argentina, Mr. Templeman said. While he believed that the balance of payments need and cooperation tests had been met, there remained some uncertainties about the temporary nature of the shortfall and about whether it was largely outside the control of the authorities. Those uncertainties principally concerned oil seeds and beef.

In the case of oil seeds and products, a glut of world production had led to a substantial drop in prices in recent years, Mr. Templeman noted. No price recovery was expected in the first shortfall year, and only a modest recovery was foreseen for the second shortfall year. However, although the volume of oil seed exports would be stable in the first shortfall year, a substantial increase in export volume was projected in

the second shortfall year. That pattern raised two questions: the first was related to the likelihood of a modest price recovery, even in the second shortfall year; and the second related to concerns about whether excess production in Argentina had contributed to a world glut and thus whether the effects of such excess output were really outside the control of Argentina. He recognized that the latter question went beyond the case under discussion but he wished to underline once again the general problem. His other question concerned whether the outlook for beef and beef product exports adequately reflected the effects of the European Communities' agricultural policy on Argentina's export markets. Subject to the staff responses to those questions, he could support the request for a compensatory financing purchase in its revised form.

Mrs. Ploix said that she supported the proposed decision.

Mr. Zecchini recalled that when the Executive Board had last discussed Argentina's request for a purchase under the compensatory financing facility, his chair had supported the request on the ground that all the criteria for granting use of the resources of the facility had been met. In spite of significant new developments in the economic scenario of Argentina, the conditions for granting and implementing the request were still met. The major developments pertained to the amount of the drawing and to the requirement of cooperation with the Fund. The amount of the shortfall presented in the supplementary staff paper had been increased, but he had no objection to the request for a larger drawing, although there might be room for some doubt about the rapid recovery of beef and cereal production and consequently of those exports in 1988.

Most of the shortfall was due to causes outside the authorities' control, specifically, the decline in unit export values for agricultural products, oil, and some manufactured goods, Mr. Zecchini added. For all those three categories, excess supply over demand on a worldwide scale was mainly responsible for the weakening of market prices. For some agricultural products, adverse weather conditions had affected negatively the export capacity of the country. In contrast, the volume of exports of beef and oil products had been influenced respectively by fiercer competition in foreign markets and restructuring of production, both of which reflected policy decisions. Nevertheless, the impact of those controllable phenomena represented a relatively small portion of the shortfall.

Turning to the requirement of cooperation, the authorities were trying to correct the recent unsatisfactory performance of the economy by introducing new measures and strengthening their adjustment efforts, Mr. Zecchini observed. He would comment on those measures when the new program under the stand-by arrangement was discussed on July 23. It was encouraging to note already that Argentina had regained the confidence of the banking community in support of the program: banks had already pledged 99 percent of the new money involved in the financial package. The new agreement between the Fund management and the Argentine authorities was also a good signal of constructive cooperation with the Fund in adjusting

the external imbalance. Furthermore, the position of his chair was that the conclusion of a stand-by arrangement was not a necessary condition for the approval of a drawing under the compensatory financing facility.

Mr. Goos considered that all the requirements for Argentina's use of the resources of the compensatory financing facility had been met. Therefore, he joined others in supporting the request.

Mr. Sengupta recalled that in February, his chair had supported Argentina's request for a stand-by arrangement, which had been approved in principle in the expectation that the official and commercial creditors would shortly meet the balance of payments financing need, making it possible for the compensatory financing purchase to be transacted. He was glad to learn that Argentina's efforts to secure agreement on the financing package had been successful. The Board would have a chance to review the program under the stand-by arrangement in the near future.

While Argentina's request for a purchase of SDR 518.8 million would raise its outstanding drawings under the compensatory financing facility to the maximum of 83 percent of quota, Mr. Sengupta continued, the export shortfall was estimated at SDR 865 million, well in excess of the proposed purchase. He had taken note of the larger access that had become available as a result of scheduled repurchases of outstanding compensatory financing drawings. However, he wished to reiterate the position taken by his chair in February, and at other times, that ways should be sought to improve the scope of the compensatory financing facility, particularly in view of the current depressed commodity prices faced by many developing countries. Needless to say, he agreed with Mr. Zecchini that approval of drawings under the compensatory financing facility should not be related to any other use of Fund resources requiring a program.

Mr. Lankester remarked that on balance he could support Argentina's request, although his authorities had reservations on some points. First, the very short time given to Executive Directors to study the request was less than satisfactory. Although the Board had approved a drawing under the compensatory financing facility in principle in February, the request under consideration was in effect a new one in that the amount of the proposed drawing had been increased by one third and the shortfall calculation had been substantially revised. Two days did not seem adequate to make a full assessment of the request.

Second, the test of cooperation was a matter of some concern to his authorities, Mr. Lankester commented. As Mr. Foot had stated in February, the very broad interpretation given to the concept of cooperation by the Managing Director at that time had given rise to serious doubts. The particular reservation of his authorities was related to the provision that a member should be deemed to be cooperating with the Fund even if it were not in compliance with the stand-by arrangement, as long as it was actively engaged in negotiations for a new program. Those were precisely the circumstances that had arisen, and nothing had happened since February

to lessen his chair's concern. The issue was particularly important because there appeared to be some doubt as to whether the present circumstances constituted cooperation with the Fund in terms of Decision No. 7528-(83/140), adopted September 14, 1983. The relevant guidelines stated: "The existence of a satisfactory balance of payments position (apart from the effects of the shortfall) or the existence of and broadly satisfactory performance under an arrangement with the Fund, or the adoption of such an arrangement at the time the request for a CFF purchase is made, will be considered to provide evidence of cooperation." The Board was not being asked to approve a new arrangement at the time of the request, and it was not in a position to form a definitive view on whether the "member's current and prospective policies were such as would, in the Fund's view, meet the criteria of the use of resources in the credit tranches." The authorities' letter on economic policy had been received only the previous day, and the other relevant staff papers had not yet been issued. He felt sure that it would have been very much easier to say that the cooperation test had been met if the staff papers on the stand-by arrangement and the request for a compensatory financing transaction were being considered together, although he recognized the impediments to such a procedure.

Mr. Archibong said that as had been noted in the Board's February discussion, Argentina's export shortfall was temporary and reversible, and had been caused by factors beyond the authorities' control. The balance of payments need was clear and the cooperation requirement, in his view, had been met. Therefore, he supported Argentina's request for a purchase under the compensatory financing facility.

Mr. Yamazaki considered it regrettable that the stand-by arrangement, which had been approved in principle, had not yet become effective despite the fact that the critical mass had been achieved already. Of course, the speedy attainment of the necessary support for the financial package was a welcome development. Nevertheless, he had been pleased to receive the letter of intent of the Argentine authorities that would be the basis for completing the review of the stand-by arrangement. He looked forward to discussing the revised economic program in the near future.

Although it was unusual to approve a compensatory financing purchase preceding the effective date of a stand-by arrangement, Mr. Yamazaki remarked, he understood that the Board had agreed in February 1987 that the bridge loan to Argentina should be repaid with resources from the purchase under the compensatory financing facility, if the stand-by arrangement did not become effective by July 15. On the basis of the policies that Argentina was adopting, he could consider that the requirement of cooperation for the proposed purchase had been met, and he could therefore go along, on an exceptional basis, with approval of the compensatory financing purchase preceding the coming into effect of the stand-by arrangement.

As for the request for compensatory financing itself, he noted that all the requirements of the decision on the compensatory financing of export fluctuations had been met, Mr. Yamazaki concluded. Therefore, he could support the proposed decision.

Mr. Ovi said that like Mr. Lankester, he felt somewhat uneasy about the decision that the Board was being asked to take. While he fully agreed that the export shortfall in itself justified a compensatory financing drawing by Argentina of the amount in question, the procedural aspects were causing him a number of difficulties. On February 26, the Board had approved in principle a request for a compensatory financing drawing of close to SDR 390 million, the amount to be released by July 15, provided Argentina continued to cooperate with the Fund. During the discussion, the Managing Director had made it clear that even in the case of nonperformance under the stand-by program, Argentina's willingness to continue deliberations with the Fund would satisfy the criterion of cooperation. A number of chairs including the Nordic chair had expressed reservations about stretching the cooperation requirement thus far. Had the requested purchase been for the same amount, approval would not have been in doubt, but the amount had increased by SDR 130 million.

Therefore, it seemed to him that legally, a request for a larger drawing, or at least for the additional amount, should be treated as an entirely new request, Mr. Ovi continued. If so, the request would have to be considered on its own merits. There again, the question was raised of whether the requirement for cooperation in the upper tranche of the facility had been met; it could hardly be claimed that a broadly satisfactory performance under the arrangement was in existence. No new arrangement had been entered into at the time of the request for a compensatory financing purchase, and whether or not the member's conduct of current and prospective policies were such as to meet the criteria for use of resources in the credit tranches was also an open question. Therefore, a decision to approve the request would seem to presuppose that the Executive Board would agree on July 23, 1987 to the revised program under the stand-by arrangement. Yet the material provided for the discussion of the request for compensatory financing offered little opportunity for reaching such a conclusion at the present stage.

Having made those remarks, Mr. Ovi concluded, the serious impact of the decision before the Board and the timing problems involved had left the Managing Director with little choice. Accordingly, he was willing to go along with the proposed decision.

Mr. Salehkhou said that he supported the proposed decision. He also associated himself with the concerns expressed by Mr. Kafka on the consequence of the requirement of cooperation, which had led to approval in principle in February and the delay in the purchase under the compensatory financing facility.

Mr. Rye said that he supported the proposed decision. He had every sympathy with the Argentine authorities in their efforts to cope with major natural disasters and with extreme marketing difficulties for many of Argentina's rural products, circumstances with which Australia was only too familiar. However, he also agreed with Mr. Lankester that the Board had been given what could only be described as an absurdly short time to consider the matter. Even though the circumstances were peculiar to the case of Argentina, he hoped that no precedent would be set for consideration of such matters in the future. He also shared much of Mr. Lankester's concern about whether the test of cooperation could be truly said to be met.

Mr. Massé remarked that he had listened with care to the various statements put forward, including those of Mr. Lankester, Mr. Rye, and Mr. Ovi. In the circumstances, and after taking account of the various arguments, he had concluded that on balance, his chair could support the proposed decision.

Mr. Dai said that he supported Argentina's request for a compensatory financing purchase.

Mr. Ebrill commented that in light of the discussion, he too could go along with the decision.

Mr. Schurr said that he supported the proposed decision.

The staff representative from the Research Department noted that a question had been raised about the possibility that Argentina's own oil seeds output had contributed to the declining trend in world prices and that to that extent the export shortfall should not be considered to be outside the control of Argentina. It should be noted that although Argentina's own supply of oil and oilseeds had increased sharply in the current decade--having in fact doubled from 1981 to 1986--the aggregate volume of exports of oil and oilseeds had remained unchanged in 1985 and 1986, the shortfall year. Even though exports had increased over the years, Argentina's own supply still accounted for a rather small share of the total world supply--less than 5 percent. The long-term increase in the production of oilseeds might have affected the trend in the price of oilseeds--no doubt to an insignificant extent considering the small share of Argentina's supply, even at present levels. But it would not be reasonable to infer, given the fact that there had been no change in 1986 in Argentina's supply, that Argentina had contributed to the decline in prices for that year. In fact, there had been sharp swings in the price of oils on the world market over the past few years. The price had risen sharply in 1983-84 when world supplies had declined--at a time when Argentina's own production was increasing--but the subsequent increase in world supplies had been accompanied by a significant decrease in prices of 25 percent in 1985, followed thereafter by a decline of 15 percent in 1986. In sum, it would be reasonable to assume that Argentina's own production increase over the years might have contributed to the long-term trend in prices of oils; but it would not be reasonable to claim that its actions had contributed to the deviation from trend in the shortfall years.

With respect to the projections for exports of beef and beef products, the staff representative from the Research Department observed that the competition faced by Argentina was largely in respect of exports of fresh or chilled beef. Exports of beef products had been growing substantially, having increased by 27 percent in the shortfall year, whereas beef exports had declined. The expectation was that output and exports of beef products would continue to expand, given existing capacity and recent information that had become available to the staff about sales contracts concluded in the early part of 1987 for delivery well into 1988.

The staff representative from the Legal Department said that the proposed decision was for a larger purchase under the compensatory financing facility than the one that had been approved in principle in February, and it therefore had to be considered on its own merits. For that reason, concern had been expressed by some Directors about the test of cooperation being met on the merits of the revised request, rather than in the light of what was stated in the decision approved in principle in February. The fourth test of the guidelines on conditionality stated that "if a member's current and prospective policies were such as would, in the Fund's view, meet the criteria of the use of resources in the credit tranches, the member would be deemed to have been satisfactorily cooperating with the Fund, even though such use was not contemplated at the time of the CFF request." As the Acting Chairman had informed the Board, satisfactory arrangements had just been completed to meet Argentina's balance of payments financing needs for 1987. In addition, Directors had received a copy of the letter supplementing the letter of intent considered by the Executive Board in February, and they were aware that management had decided to recommend that the stand-by arrangement for Argentina be approved as of July 23, 1986. The staff paper on the revised economic program, which would be issued that day, contained a firm recommendation for approval of the stand-by arrangement. In the view of the staff, the requirements for the drawing to take place had been met, and the proposed decision had thus been submitted to the Executive Board for its consideration.

Mr. Kafka considered that the legal opinion that the request for the compensatory financing purchase, because it was larger than the one that had been approved in principle in February, had therefore to be considered on its own merits was an inappropriately narrow interpretation. In February, the Executive Board had approved a compensatory financing purchase in the maximum amount available to Argentina at that time under the access limits; the decision before the Executive Board again allowed Argentina to purchase the maximum amount available to it currently. He was not at all sure that it was necessary to go to the lengths to which the staff representative from the Legal Department had gone to justify the purchase, by bringing in, inter alia, the curious concept of the intention of the management to recommend action that fulfilled the condition of cooperation.

The staff representative from the Legal Department recalled that the decision adopted by the Executive Board on February 26 stated that the Fund expected to receive a request for a purchase equivalent to SDR 388.7 million under the decision on the compensatory financing of export fluctuations. The decision went on to say that the Fund approved the purchase subject to confirmation of a shortfall of an amount at least equal to the drawing as of the effective date of the approval. As the staff read that decision, it meant that recalculations would be made only to confirm the existence of a shortfall of that amount. Therefore, the approval in principle was for an amount of up to SDR 388.7 million.

Mr. Goos remarked that he would be concerned if the Fund went to the lengths that Mr. Kafka apparently had in mind of approving a request for purchases of a certain amount, which happened to be a certain percentage of access, and then later on aiming at retaining that access limit. Such an approach would differ from the policies established by the Board, from which there should be no departure.

Mr. Feldman remarked that the doubts expressed by some Directors about the procedural aspects of the test of cooperation indicated that there might be an inclination to strengthen the link between the use of resources under the compensatory financing facility and programs supported by stand-by arrangements. Presumably that issue would be discussed when the Board reviewed the compensatory financing facility in the near future.

The Executive Board then took the following decision:

1. The Fund has received a request by the Government of Argentina for a purchase of SDR 518.765 million under the Decision on Compensatory Financing of Export Fluctuations (Executive Board Decision No. 6224-(79/135), adopted August 2, 1979).

2. The Fund notes the representations of Argentina and approves the purchase in accordance with the request.

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

Decision No. 8636-(87/101), adopted
July 10, 1987

2. NEW ZEALAND - 1987 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1987 Article IV consultation with New Zealand (SM/87/129, 6/8/87 and Sup. 1, 7/7/87). They also had before them a background paper on recent economic developments in New Zealand (SM/87/140, 6/25/87).

Mr. Rye made the following statement:

My authorities agree generally with the staff assessment of the economic situation of New Zealand. They consider that the report provides a balanced view of the direction and consequences of the policy course adopted by the Government.

My statement concentrates on three areas: the economic management process in the last three years; economic developments and trends since the staff visit; and future economic policy and priorities.

Since mid-1984 New Zealand has been engaged in a process of radical economic reform--radical against the history of the previous four decades and radical in its comprehensiveness. The impetus for the change lay in the economic stagnation of the preceding ten years when real increases in GDP averaged only about 1/2 percent per annum. There was widespread acceptance of the need to change, and general agreement about the desirable direction for change--that is, away from short-term demand management with a heavy interventionist bias to a more medium-term focus with an emphasis on efficient operation of markets and responsiveness of economic agents to external developments.

The adjustment process has continued over the past 12 months. A major initiative included the reorganization of several government departments into state-owned corporations with clearly defined commercial objectives, paying both dividends and taxes. Changes in the law relating to labor relations were enacted to introduce more flexibility into the industrial relations regime; while less sweeping than some commentators, including the staff, have advocated, these changes do represent a significant step in an evolutionary process of reform in this sensitive area.

Already New Zealand is starting to see the benefits of the government commitment to withdrawal from the wage-fixing process. In contrast to the 1985/86 wage round, the latest wage round beginning September 1986 yielded a good outcome with a wide degree of dispersion of wage settlements. This represents a significant change in New Zealand wage-fixing history, which has traditionally been centralized and dominated by strong formal and informal relativities.

Naturally, the adjustment program has not been without its costs and dislocations. Inflation increased rapidly, especially with the introduction of a 10 percent value-added tax (VAT) in October 1986. Nominal and real interest rates have been extremely high and there have been marked fluctuations in the exchange rate. Unemployment has gradually increased to the current rate of about 5 percent. Also there has been a considerable loss of income and wealth for the farming community with the abandonment of nearly

all price support schemes and agricultural subsidies. Nevertheless the authorities are convinced that the foundations have been laid for future growth at a higher and more sustainable level.

The staff supplement (SM/87/129, Sup. 1) issued on July 7 summarizes the main economic trends since the staff visit in March/April.

The major concern expressed by the staff in its main report (SM/87/129) related to the fiscal position. My authorities point out that the fiscal situation is substantially better than appeared at the time of the staff visit. On the traditional budget presentation the Government's financial accounts are expected to record a surplus in 1987/88 for the first time in 35 years.

The Government believes that it is important to keep in view a variety of concepts in analyzing the fiscal position, and the June budget contains a number of technical annexes which explain different budget concepts.

The trends in the deficit position can be summarized as follows:

	Actual			
	1984/85	1985/86	1986/87	1987/88
	(Percent of GDP)			
Traditional budget deficit/ surplus	-7.2	-4.2	-3.8	+0.7
Financial deficit 1/	-6.3	-3.1	-3.7	-2.2
Cyclically and inflation adjusted financial deficit 2/	-3.5	-1.1	+0.8	+1.0

1/ The deficit as presented in the IMF data base on Government Financial Statistics.
2/ Represents the financial balance minus adjustment for cyclical fluctuations and inflation, rounded to the nearest $NZ 50 million.

The assessment of the outlook for the fiscal deficit for 1986/87 available at the time of the staff consultation was prepared in December 1986, before the March quarter tax flow period. Although it was clear at the time of the consultation that the tax take was ahead of forecast, the magnitude of actual collections exceeded even those revised expectations. Tax revenues were approximately 2 percent of GDP higher than forecast, and the financial deficit outturn (-3.7 percent) was correspondingly better than that expected at the time of the consultation.

The higher tax revenue was due to a number of factors. New data suggest that nominal incomes grew more rapidly in 1985/86 than had been assumed. As well, the restructuring of the tax system and closing of tax loopholes have helped to broaden the tax base and brought into the tax system activities that were previously untaxed. Expenditure, after allowing for one-off items, has remained broadly flat in real terms over the last two years.

It is expected that much of the higher tax proceeds in 1986/87 will be ongoing. Nominal incomes are likely to show continued growth. Further measures to reduce tax avoidance were announced in the 1987 budget. Expenditure in real terms is expected to remain flat over the next year.

Monetary conditions have remained firm since the staff's visit. However the structure of interest rates has moved down sharply since April, with the three-month commercial bill rate falling from about 27 percent to its current level of 19 percent. Long-term rates have also fallen. Interest rate volatility is much reduced and confidence and stability have returned to financial markets after a period of uncertainty associated with the March tax drain period.

The increase in the CPI of 2.3 percent in the first quarter of 1987 was lower than generally expected. Inflation expectations appear to have adjusted downward since the consultations.

The current account balance has continued its steady improvement. The deficit for the year to May 1987 was $NZ 1,878 million or 3.6 percent of GDP, down from $NZ 2,053 million (4 percent of GDP) for the year to March 1987.

Revised current account forecasts project a decline in the deficit to about 3 percent of GDP in the year to March 1988. This is well below the 4 percent forecast suggested in the staff report, and a further decline is expected in 1988/89 to about 1.9 percent of GDP. These forecasts are at variance with the future track suggested in scenario 1, Table 5, of the staff report, and indicate a faster reduction in debt and debt-servicing to GDP ratios than projected.

My authorities conclude that the trends since the staff's visit show continuing improvement in the imbalances in the New Zealand economy. In particular, the fiscal position, about which the staff has expressed particular concern, is better than appeared at the time of the consultations, and it has continued to show substantial improvement. The improving trend in the current account has continued and inflation is expected to decrease.

The authorities remain committed to the strategy of promoting private sector initiative and correcting economic fundamentals in the medium term. In the area of government finances, the Government has stated in the latest budget that its major priorities are to reduce the public debt burden and to ensure that welfare expenditure is more efficiently targeted.

In the supplement the staff has suggested that increased emphasis on expenditure restraint is appropriate. My authorities agree, but consider that the staff assessment underrates their efforts in curtailing government expenditure in recent years. These efforts have been masked by the very rapid rise in public debt servicing. In the last ten years the public debt has risen from $NZ 6.3 billion to $NZ 42.5 billion, and interest payments on that debt rose in the same period from $NZ 400 million to over $NZ 4,000 million. In 1986 almost one quarter of New Zealand's total tax revenue was used to meet these payments. These very large increases in public debt were the result of continued imbalances over a long period in both the fiscal and external positions. Moreover, last year the Government took over a large volume of debt associated with some major projects that had been either directly or indirectly guaranteed by the Government. The recent budget signals the Government's determination to reduce the public debt. This is the prime reason for the announcement to sell off government assets and introduce private shareholding in several government-owned enterprises.

Welfare spending accounts for about 60 percent of total government expenditure in New Zealand. Last year a Royal Commission was established to look at fundamental social policy issues. The budget announced the establishment of several task forces to review more specific administrative matters in the welfare field. These moves signal the Government's resolve to design a welfare system that will better reflect the interests of both the providers and recipients of social services.

Extending his remarks, Mr. Rye said that his authorities now expected a current account deficit of 3 percent of GDP in the year ending March 1988, and 1.9 percent in the following year. Those projections were considerably better than those shown in Table 5 of the staff report (SM/87/129), even on the assumption of a modest fall in the real effective exchange rate, under the alternative staff scenario, a fall which had not in fact occurred. He was not making a criticism of the staff, but rather a request to the Board that particularly in the case of small countries such as New Zealand, where external developments could have a very large influence on trends, less weight be attached to predicting the future in quantitative terms.

Mr. Ismael made the following statement:

I agree with the broad thrust of the staff appraisal. I commend the authorities for the further progress made in their medium-term program of structural reform and deregulation, especially the recent measures to improve the organization and management of the public sector. However, I cannot help having a sense of uneasiness at the continuing large financial imbalances, although I note that these are expected to be reduced in the 1987 budget. My main concern is that the uneven pace of liberalization and reform in different areas may make the transitional costs too high, as well as being borne disproportionately by the tradables and agricultural sectors. These strains are being reflected in low growth, declining private investment, and high interest rates, even as the Government's financial deficit and the external current account deficit continue to be relatively large. The reform program may be endangered by prolonged slow growth and rising unemployment if these strains are not reduced. It is worth repeating that growth is essential to sustained adjustment.

I share the concern of the staff that progress in reducing the large imbalances in public sector finances has been much slower than desirable, despite the measures aimed at fiscal consolidation. After the initial success, I note that it proved difficult to reduce the budget deficit much below 4 percent of GDP because of the built-in rigidities in expenditure, especially the increasing interest payments on the public debt. In terms of the Government's financial deficit, which is not affected by putting the borrowing of public enterprises "off-budget," the progress in reducing the imbalance was reversed in 1986/87. I welcome the expected reduction in the financial deficit in 1987/88 indicated in Mr. Rye's statement.

A reduction of the financial imbalance in the public sector therefore appears to be the most urgent problem, which the authorities are also keen to address. In this connection, I note the view of the staff that considerable room may exist for reducing social expenditure and transfers, an important component of aggregate expenditure which is still relatively untouched by the austerity measures. I would urge the authorities to persevere in their efforts to reduce the financial deficit through expenditure reduction and appropriate user charges. Otherwise, the public debt and the debt/GDP ratio would continue to rise, building up greater rigidities that would hamper efforts to contain the fiscal deficit in the future. In addition, the upward pressure on interest rates would persist in straining the budget.

I therefore welcome the authorities' continued commitment to further fiscal consolidation, as well as their attitude of not regarding any expenditure as immune from budgetary cutbacks. I am also glad to note that a major improvement is expected in the 1987 budget recently adopted. Fiscal policy is on the right track. What is still needed is a sustained effort to reduce the public sector deficit even further.

I must admit that recent monetary developments are difficult to interpret because of pre-emptive spending before the new goods and services tax took effect, as well as the shifts in demand for money. Nevertheless, it is clear that monetary policy had been overburdened in the authorities' fight against inflation, reflecting the slow fiscal adjustment. Given the resurgence in monetary and credit growth after mid-1986, I agree that the authorities might not have had much choice in sharply tightening monetary conditions in late 1986. Nevertheless, high interest rates are now imposing transitional costs that are greater than necessary. I note with concern that domestic investment has slackened markedly with rising unemployment, while the adjustment costs borne by the tradables sector have intensified. In addition, the real effective exchange rate has appreciated to a level close to that prior to the devaluation of 20 percent in July 1984. I wonder whether some of these costs could have been reduced with a prudent recourse to net foreign borrowing, rather than letting the Government compete for limited domestic resources to meet its entire funding needs.

Although I agree with the staff that a firm monetary policy stance needs to be maintained until the public sector's claims on private savings can be reduced, I feel that interest rates are still too high, despite their recent decline. Apart from the adverse impact on investment and growth, one undesirable side effect is the funding of the external current account deficit with volatile short-term capital inflows, or "hot money," which has also led to an appreciation of the exchange rate. Such a buildup of private short-term debt is inherently more unstable than a managed recourse to official net external borrowing. Hence, interest rates would need to be brought down gradually with stronger support from fiscal policy.

The main area of concern in the external sector is the appreciation of the real effective exchange rate, which could erode New Zealand's competitive position. Such appreciation does not appear appropriate, given a current account deficit close to 4 percent of GDP and little prospect for rapid improvement. However, since an inappropriate exchange rate is only a symptom of underlying imbalances in the economy, I agree with the staff that the effective solution would be an acceleration of the process of fiscal consolidation and improved flexibility in the goods and labor markets, rather than sustained intervention.

Another matter of concern is the effective funding of the current account deficit through private capital inflows. Given the Government's policy on net foreign borrowing, I must express my doubts about the estimates on growth in external private debt on page 9 of the staff report. I suspect that a large amount of domestic bank deposits must be owned by nonresidents taking advantage of the very high interest rates. Perhaps the staff can explain whether such deposits are considered part of New Zealand's total external debt, and whether the Government took this factor into account in forming its policy of not resorting to net foreign borrowing. I have in mind here my earlier point that managed recourse to foreign savings through official borrowing might be better than relying on volatile short-term private inflows.

In the area of trade policies, I welcome the recent moves by the authorities to reduce tariffs and import licensing under the import liberalization program. However, I note that the sectors covered by industry plans are still characterized by low levels of import access. I urge the authorities to speed up the pace of reducing import protection in these sectors, so that resources can shift to more efficient export production.

I believe that the marked moderation of pay increases in the private sector in the 1986/87 wage round was appropriate, given the need to reduce inflation and increase external competitiveness. I welcome the intention of the authorities to increase the flexibility of wage bargaining structures and labor market institutions through the new Labor Relations Bill. Continued moderate increases in wages would be an important part of the adjustment process. Here again, firm financial policies would complement strongly the institutional and regulatory reforms to improve the functioning of the labor markets. Like the staff, I am dubious about the provision in the new labor legislation specifying the minimum size of unions.

In conclusion, I fully support the general economic strategy of the authorities, but would urge them to remedy some of the shortcomings with the aim of reducing its high transitional costs. I am glad to note that further efforts in this direction are being made in the 1987 budget. I also support the call of the authorities for protectionism and subsidies in other major industrial countries to be reduced, so as to create a more favorable external environment for a successful adjustment.

Mr. Goos made the following statement:

I can broadly support the thrust of the staff appraisal, both in the report and in the supplement. Therefore, I will

concentrate on aspects relevant to New Zealand's external competitiveness, and thus to its external current account and foreign indebtedness.

One of those aspects that requires particular attention is monetary policy. While I agree with the staff that the difficulties encountered last year were related in part to the size of the fiscal deficit as well as to the transitory effects of the tax reform and the uneven pace of financial liberalization, it seems that much of the blame has to be put on the authorities' "eclectic" approach to monetary policy. Based on the staff report, one is tempted to actually speak of "erratic" rather than "eclectic" policies. I am, of course, referring to the "unintended easing" of monetary policy in mid-1986. Whatever may have caused this easing, which unfortunately is not explained in the report, it apparently prompted the monetary authorities to take strong off-setting measures, thereby inducing an exceptionally sharp increase in short-term interest rates, which in turn gave rise to substantial capital inflows and strong upward pressure on the exchange rate. While the authorities might just have overreacted--as one could conclude from the resulting yield curve with its unusually steep inverted slope--the undesirable effects of this development on domestic investment activity and the external current account seem obvious. Thus, the authorities would probably be well advised to aim at a more stable and predictable path of monetary policy so as to avoid the kind of immediate frictions that occurred last year and to influence favorably and stabilize market expectations.

However, there would still remain a potential policy conflict. Interest rates are clearly only one of the factors influencing exchange rate behavior. Improvements in fundamental or so-called underlying economic developments can play at least as great a role in the medium term. Then one would expect that the projected (or intended) improvement in such areas as the fiscal position, the investment climate, and inflation would induce further appreciation of the exchange rate, thereby again threatening the critical objective of reducing the external current account deficit.

As a possible solution to this dilemma, it might be advisable to depart somewhat from the principle of fully funding the fiscal deficit domestically and rather finance part of the deficit through official external borrowing. At first glance, such an approach might appear to run counter to the admittedly urgent need to contain the external debt burden. However, by reducing the public sector's claim on domestic savings one could expect to relieve the pressure on domestic interest rates and hence on the exchange rate, which in turn would help accelerate external adjustment. In the end, the total increase in external

debt might be less with this approach than with comparatively higher domestic interest rates. Perhaps the staff or Mr. Rye would care to comment.

In sum, the authorities have achieved commendable progress so far in their adjustment strategy. To be sure, difficult tasks remain to be tackled in the period ahead. However, most recent developments and policy decisions suggest, in general, that the authorities are moving in the right direction.

Mr. McCormack made the following statement:

During the Board's discussion of the last Article IV consultation with New Zealand, this chair commended the authorities on the radical changes which had taken place in the orientation of economic policy, but struck a note of caution. Both the speed and the path of adjustment were uncertain and entrenched attitudes were proving hard to overcome. The general principle that seemed to emerge from the New Zealand experience was that the chances of the strategy reaching its objectives greatly depended on the credibility of the Government, and the conviction and persistence with which it implemented its policies. The experience of the past year has been reassuring. The authorities have pursued their objectives of general economic and financial liberalization with commendable determination. There would now appear to be no doubt about the course on which the authorities are set.

Since I support the thrust of the staff appraisal, I will focus my remarks first on the overall structure and balance of the policy program of the New Zealand authorities. At the last consultation, a number of Directors mentioned that the experience of New Zealand was relevant to other countries. I would like to emphasize that, as the staff noted, the pace of liberalization in the main economic sectors has been uneven. As the authorities have recognized, the precise sequence in the reforms may not have conformed to the theoretical ideal but rather may have been dictated by considerations of feasibility. New Zealand's experience suggests that perhaps greater respect might be paid to these theoretical ideals, which are founded on considerable experience. A purely theoretical consideration of the pace and order of reform in New Zealand could have anticipated some of the difficulties that eventually were encountered. Perhaps a practical course for countries to adopt before embarking on such comprehensive programs of reform would be to respect the theoretical. The difficulties being experienced in the monetary area in particular suggest the validity of such concerns.

Regarding the balance to be struck between fiscal and monetary adjustment, policy in New Zealand has been put under significant strain because of the slow adjustment of fiscal imbalances.

Continuation of substantial fiscal deficits, and expectations about their financing implications, have undoubtedly contributed to the persistence of high real interest rates and a tendency toward real effective appreciation of the currency. Both of these have had adverse implications for the volume of economic activity and for the current account of the balance of payments. Continued reduction of the fiscal imbalances is therefore imperative. Clearly, the focus of attention must be on expenditure reduction, as the scope for revenue increases seems quite limited. There appears to be room for savings in the area of social transfers. In this connection, the authorities' emphasis on developing cost effective delivery systems in the social area is to be commended. Further, more radical privatization would increase the incentives under which the various public entities operate and improve the fiscal position. The transformation of government departments into corporations with majority state shareholding may not be sufficient. Perhaps the staff could comment on this issue.

Within the financial area, there has been considerable deregulation, which has complicated the formulation and implementation of monetary policy. New Zealand's experience in this respect is by no means unique. The United States, the United Kingdom, and Canada, to mention just a few, have experienced similar difficulties as a result of financial deregulation and innovation. However, the problems seem more acute in the case of New Zealand. Interest rates and monetary aggregates have been disturbingly volatile. We welcome many of the elements of New Zealand's monetary policy. In particular, the principle of fully funding the public sector seems appropriate.

Having said that, I cannot entirely agree with the authorities' skepticism about the usefulness of monetary aggregates as a guide to the implementation of monetary policy. The experience of June to September 1986 when there was an unintended easing of monetary conditions and a subsequent tightening--deemed excessive by many commentators--suggests that some guiding principle for monetary policy would be desirable. Judgment based on a large number of monetary indicators would not seem to provide the type of clear, consistent guidance to the private sector which is required, if inflationary expectations are to be durably reduced.

I note that the new prudential supervisory legislation, which came into effect on April 1, 1987, was not based on the use of compulsory asset ratios or liquidity requirements. I also understand the desire of the authorities, in the design of their regulations, to avoid considerations of moral hazard. That said, I wonder whether the authorities were entirely wise in deviating so significantly from common international practice at a time when the financial sector was in a state of transition. This is not to question the logic of the New Zealand authorities' position,

but rather to wonder whether a more conventional approach might not have been justified at this particular time. Perhaps the staff might comment on this admittedly delicate issue.

Mr. Ebrill made the following statement:

The authorities continue to make significant progress on the path to implementing a fundamental reform of their economy. Many of the measures taken have been far-reaching and courageous, and I commend the authorities for their efforts. Since I am in general agreement with the overall thrust of New Zealand's reform strategy, I will limit myself to comments on some of the details of that strategy, with the understanding that these comments should in no way be viewed as reducing my overall endorsement of what has been achieved.

As the New Zealand case demonstrates, when fundamental reform is involved, time is needed before the effects of that reform will be fully realized. Specifically, even though many aspects of economic life in New Zealand have by now been liberalized, the overall rate of growth remains sluggish. Nonetheless, I believe that this will be temporary and that, from a longer-run point of view, as the imbalances continue to decline, New Zealand will benefit handsomely from the measures the authorities have adopted. What is needed is patience and persistence.

As for the appropriate stance of policy, other Directors have comprehensively addressed monetary policy. For my part, I would like to emphasize the need to sustain efforts to reduce the fiscal deficit. Otherwise, as is highlighted by the negative, and high, yield curve, monetary policy will be held hostage and inertial inflationary expectations will remain high. In this context, I welcome the fact that the latest budget represents a further tightening of fiscal policy; as Mr. Rye noted in his opening statement, the steady decline in deficits has been associated recently with a decline in interest rates. These developments are all in the right direction. However, I do believe that the truer measure of the deficit places all proposed asset sales below the line. I recognize, of course, that in the case of New Zealand, the trend is toward a tighter fiscal policy, irrespective of how asset sales are treated.

I welcome the fact that the new state-owned enterprises are to be managed on the basis of commercial criteria and I understand that logic, therefore, suggests that their borrowing be treated just like any other commercial borrowing. Specifically, such borrowing should not be counted as part of the overall fiscal deficit. However, the true test of this logic will only occur when the possibility of default on some of these obligations arises and the authorities demonstrate that they are unwilling to underwrite them.

I would like some elaboration of what the staff means when it states that state-owned enterprises will be managed on the basis of "commercial criteria." In this connection, I would like to make a theoretical point, and to express a word of caution. Specifically, I sense from the staff report that managers will be expected to set prices to cover all costs, while their pricing policies will naturally be constrained by the fact that their markets are contestable. If my assumption is correct, my concern is that this contestability concept, which is associated with the work of economists such as Baumol, Willig, Bailey, and others, and which implies that potential rather than actual market structure is relevant, may not apply to the New Zealand situation. To elaborate, contestability models rely on the threat of competition, rather than on actual competition, to ensure that efficient prices, or Ramsey prices as they are better known, are charged. For these models to work, barriers to entry must be low. Furthermore, in any evaluation of actual market performance, there are some difficult empirical issues to resolve. Specifically, it is very hard, after the fact, to determine whether an enterprise has been charging efficient Ramsey prices as market contestability would suggest, or merely monopoly prices. Both monopolists and firms in contestable industries will operate on the inelastic portion of the demand curve, making their pricing behavior superficially similar--but the outputs they supply will be quite different. In other words, the regulatory environment in which these firms operate will be crucial to their success, and in this connection I am in full agreement with the authorities that the correct specification of this environment is more important than the question of whether privatization is appropriate.

I commend the authorities for the manner in which they have reduced expenditures. However, the ratio of expenditures to GDP remains stubbornly high. While interest payments on debt are partly responsible for this high ratio, the persistently high levels of social expenditure presumably also play a significant role. This makes the forthcoming report of the Royal Commission on Social Policy very important.

I also commend the authorities for the comprehensive nature of the tax reforms they have implemented. The manner in which they have abolished tax expenditures, such as the mortgage interest deduction, is especially noteworthy. However, the tax system has yet to be insulated from the impact of changes in inflation. Here I have in mind the tax treatment of nominal interest payments as well as the absence of a capital gains tax. I wonder if any reforms in this area are envisaged?

The thrust behind the recently enacted Labor Relations Bill is most welcome. However, the impact of this bill on the labor market should be carefully monitored. Specifically, there may be a possibility that the "opting out" provision will, in effect,

place a floor under wage settlements, thereby imparting an inflationary bias. In other words, unions whose members face tight labor market conditions would opt out of the general award system and negotiate from a position of strength, while other unions would be satisfied with the general wage award. Staff comment on this would be appreciated.

In conclusion, the authorities are to be commended for the scope and persistence of their adjustment efforts. They have certainly achieved a great deal. I am sure it will not be long before New Zealand begins to reap significant economic benefits from all its authorities have done.

Mr. Templeman made the following statement:

At last year's Article IV consultation, the Board tended in its comments to concentrate on the need for further progress in fiscal adjustment and reform and on wage restraint and a reordering of labor relations. These subjects continue to merit attention. It is somewhat surprising that more progress seems to have been made on structural reforms than on restoring a sound financial environment. Among structural adjustments, an important tax reform has been introduced, a basic reorganization of public enterprises has begun, and two labor relations bills have been proposed, one of which has been passed. In contrast, the deficit in the fiscal accounts--as measured by the financial deficit--was only slightly reversed, monetary and credit expansion proved to be excessive, interest rates were rather high and volatile, and the exchange rate has continued to appreciate.

Performance in the real economy was also somewhat disappointing. There has been virtually no real growth in the last two years and very modest growth seems in store for 1987/88. Employment growth has become negative and the unemployment rate, although low by international standards, has been increasing slowly. The outlook for investment remains quite uncertain.

Inflation performance remains unsatisfactory in relation to the goal to bring down New Zealand's inflation rate closer to that of its trading partners. Even taking into account the estimated 6 percentage point impact of the new tax on goods and services last year, the underlying rate of inflation was apparently about 12 percent. Price targets of about 8 1/2 percent for 1987/88 and about 5 1/2-6 1/2 percent for 1988/89 do not seem very ambitious. It is rather disappointing that inflationary expectations have not turned around as much as hoped, although Mr. Rye's statement does indicate that they may have moderated recently.

One bright spot has been recent evidence of wage rate restraint. Although the staff report shows a rate of increase in nominal weekly wage rates of 17.7 percent for the first nine months of 1986/87, settlements on the order of 7 percent in the private sector and 5 3/4 percent in the public sector since the last wage round began in September 1986 are more encouraging. Wage moderation may also be symptomatic of a more fundamental improvement in labor relations.

There have also been some interesting developments in labor relations as a result of the recent passage of the Labor Relations Bill and the presentation of a proposal for changes in labor relations in the public sector. However, like the staff, we are concerned about the effects of, and the priority assigned to, setting a minimum size for unions and permitting unions to opt out of national wage awards. Some further exposition of these matters would be welcome.

Fiscal adjustment remains the key to continued restoration of better financial balance in New Zealand. Considerable progress was made in reducing the financial deficit/GDP ratio from the 6-7 percent range to a range of 3-4 percent in the past two fiscal years. Still, there was a small increase in the deficit ratio in 1986/87. On the other hand, Supplement 1 to the staff report indicates that the deficit ratio in 1987/88 could fall substantially to about 2.2 percent of GDP. This would represent significant progress in fiscal adjustment. Clearly, the matter is of some urgency, as evidenced by a ratio of total public debt to GDP as of March 1987 of 86 percent and of foreign public debt to GDP of 44 percent. Similarly, the pre-emption of more than 20 percent of fiscal revenues by interest payments already limits the freedom of the authorities to shape public spending.

We welcome the assurances in Mr. Rye's statement of the strong emphasis still being given to fiscal adjustment as a means of relieving the burden now placed on monetary policy, permitting some easing of upward pressures on prices, interest rates, and the exchange rate, and eventually of encouraging investment, economic growth, and job creation. Continued focus will need to be mainly on expenditures. It is striking that social expenditures and transfers now amount to almost 60 percent of total expenditures. The Board's seminar last year on social spending in some major industrial countries provided a useful warning of the potential for future fiscal difficulties arising from this source. Therefore, we look forward with interest to the report of the Royal Commission which is expected late next year.

We welcome the October 1986 tax reform which introduced the new general sales tax (GST) on goods and services and which reduced the number of tax rates on personal income. While the reduction in the maximum rate from 66 percent to 48 percent was

substantial, even a 48 percent marginal rate seems rather high. The creation of new state-owned enterprises to separate the commercial activities of the Government from its more traditional governing functions is also a positive step, as is the initiation of sales to the public of shares in some of these entities. We do wonder, however, about the rationale for the Government's assumption of the debt of these enterprises and would welcome a fuller explanation of this action.

I have already alluded to the rapid growth of money and credit aggregates in the past year and to the high level and volatility of interest rates. To some extent, these developments may not have been foreseeable or avoidable, but their adverse effects on liquidity, inflation and inflationary expectations, and the credibility of the monetary authorities was certainly regrettable. While the situation seems to have improved recently, caution is still needed.

Considerable progress has been made in reducing the ratio of the current account deficit to GDP from the high levels reached in 1984/85 and 1985/86. Staff projections over the medium term show a deficit that would remain at about 4 percent of GDP in the foreseeable future. Under the base case scenario, this would lead to a gross foreign debt ratio of 56 percent and a debt service ratio of 27 percent in 1990/91. While under the alternative scenario, involving a modest depreciation of the exchange rate, the current account deficit ratio would be reduced perceptibly, the debt and debt service ratios would still remain rather high at about 54 percent and 25 percent, respectively. However, in his statement Mr. Rye argues that a considerably better medium-term balance of payments outcome is foreseeable. I would welcome staff comment on this.

It is not clear whether this more favorable projection involves any currency depreciation. The staff and the authorities appear reluctant to employ exchange rate policy more actively. I recognize that there could be a danger of allowing exchange rate flexibility to accommodate too rapid a rate of growth of domestic inflation, and agree that better control over domestic costs and prices would be a superior approach to maintaining international price competitiveness. But, one must ask whether progress in that area is proceeding fast enough. Comment by the staff or Mr. Rye would be welcome.

We commend the authorities for the progress being made in reducing import licensing and reducing high tariff rates. But it appears that in both areas, there is room for faster action, particularly if the medium-term balance of payments outlook is more favorable, as suggested by Mr. Rye. We hope that during the forthcoming reviews of economic sectors having industry

plans, careful attention will be given to reducing quantitative import protection and that the re-examination of tariff policy next year will focus on further moderation of tariff rates.

While some significant progress has been made in structural reforms, re-establishment of financial stability, which has traditionally been the main focus of Fund attention, has proved more elusive than expected. We urge the authorities to turn their particular attention to this matter.

Mr. Kyriazidis made the following statement:

We agree with the thrust of the staff report and with the main emphasis of the New Zealand authorities on medium-term structural adjustment policies. However, the continued loss of external competitiveness is a major cause for concern. This is a serious matter for New Zealand, which has a large current account deficit (4.1 percent of GDP in 1986/87), a significant external debt (43 percent of GDP), and an open economy, for which growth prospects are dependent on the development of the external sector.

The loss of competitiveness seems to reflect the divergence between price and wage dynamics in New Zealand and its trading partners, as well as what appears to be an abnormal development of the exchange rate. Therefore, an improvement in competitiveness will require action on those fronts.

We welcome the wage moderation that occurred during the recent wage negotiations in both the private and the public sector. However, the increase in the CPI in the last part of 1986 and early 1987 is a cause for concern, as its persistence might jeopardize wage moderation in the coming years. To this end it might be useful to receive from the staff the inflation forecast for the coming year.

Improvement in competitiveness will also have to be sought through a more appropriate evolution of the nominal exchange rate, which has been pushed out of line because of large private capital inflows as indicated in the staff report.

Inflows of private capital call into question the policy mix which can be characterized as being tight money--with high real interest rates and a steep downward sloping yield curve--designed to offset a relatively loose fiscal policy--the Government's financial deficit increased from 3.2 percent of GDP to 4 percent of GDP in 1986/87 from the previous year. The policy stance might therefore be reoriented along the following lines. Monetary policy, and interest rates in particular, could be relaxed as inflation subsides, in order to reduce the inflow of private

capital while more effective action is taken to reduce fiscal deficits, especially on the expenditure side. However, the rigidity of budget expenditures is the crux of the matter, and this is not a problem peculiar to New Zealand. We all know the extent and force of the political constraints under which many governments are forced to operate in this area. While it is important that sufficient restraint be exercised to prevent public expenditures from increasing in real terms in relation to GDP, it is useless to indulge in exhortations for expenditure reduction once a government feels it has reached the limit of what is politically possible on that score.

The ratio of expenditure to GDP peaked at 42 percent in 1983/84. After a reduction to somewhat below 40 percent in the next year, it has stabilized at this level ever since. Therefore, in the last three years no improvement has occurred. As for individual items of expenditure, current expenditures continued to increase relative to other items, mainly owing to transfers and subsidies, despite the reduction in agricultural subsidies.

On the revenue side we note the improvements that have occurred in the last three years in increasing the ratio of revenues to GDP. We are interested in learning from the staff or the authorities what the impact of the GST would be on revenues.

Finally, some scope might exist for a more active intervention policy on the foreign exchange market in order to resist the appreciation of the exchange rate, in view of the significant buildup of reserves that has occurred recently.

Mr. King made the following statement:

Let me start by saying that we found the two appendices to the background paper on recent economic developments particularly helpful.

The authorities seem to us to have made considerable progress in the past few years, particularly when their efforts are viewed in the light of the large explicit and implicit imbalances that marked the economy in the early 1980s. Significant measures have been taken to liberalize the financial, goods, labor, and external sectors, although there have, perhaps inevitably, been temporary difficulties in some areas. As Mr. Rye points out for example, inflation rose sharply following the introduction of the VAT. Overall, this reform effort is impressive and the authorities have taken significant steps in improving the medium-term outlook for the economy. There have already been signs in several sectors that these efforts are bearing fruit.

The financial sector is one example. As the staff notes, deregulation has helped to reduce interest spreads, and has increased the range of products available to companies for hedging and the like in the foreign exchange markets. As part of their effort to improve the efficiency of the financial system, the authorities have said that the intention of the new prudential legislation is not to prevent the failure of individual financial institutions but rather to allow the orderly exit of financial institutions which are in difficulties. This is a commendable intention. I note, however, that other countries have often found it very difficult to allow institutions with significant numbers of small depositors to go bankrupt. I would be interested to learn from the staff, or perhaps Mr. Rye, whether the authorities' resolve in this matter has yet been put to the test.

While on the subject of monetary and financial policies, I might note that I was slightly uncertain about the description of the objectives of monetary policy contained on page 42 of the background paper which states: "the authorities have emphasized their commitment to fully funding the net injections into primary liquidity flowing from the public account. This policy is in principle quite strict as it implies zero trend growth in the liquidity base of the financial system." Perhaps the staff could confirm if I am right in assuming from this that the authorities in fact have two separate objectives. First, that through full funding the public sector should not impart any stimulus to the financial liquidity and second, that zero trend growth in the liquidity base would be an appropriate objective over time. The former does not, of course, imply the latter as even if the public sector's effect on the liquidity base is neutral, either the private sector or the external sector could impart a net stimulus.

The authorities are also making significant efforts to improve the functioning of the labor market. The slowdown in the rate of wage increases in the 1986/87 wage round is perhaps an encouraging sign that their efforts are showing results. The recent Labor Relations Bill should further help to increase the flexibility and responsiveness of the labor market.

In that connection, I note that there seem to have been some differences of opinion between the authorities and the staff on the appropriateness of the minimum size for unions allowed under the bill. We had some sympathy with the views of the authorities on that question. Although it is difficult to know to what extent this is relevant in the New Zealand context, in the case of my own country the existence of several small competing unions within an industry, each representing different groups of workers, has on occasion resulted in considerable problems owing to conflicts of interest between the different unions. Of course, we understand

the staff's belief that it would be helpful to facilitate decentralized bargaining, but we wonder whether the best way to achieve this might not be within the context of larger unions.

In any case, it is clear that significant rigidities remain within the labor market, and I hope that the authorities will be able to take further measures to improve performance in due course.

The authorities have also made substantial progress in improving the performance of the public sector. In part these efforts have taken the form of hiving off the commercial functions within government departments into free-standing corporations. To judge from the staff report, these measures have already led to increases in efficiency.

If I understand the situation correctly, the newly established state-owned enterprises are required to raise financing on the private markets to replace the debts they owe to the Government. The treatment of the resulting flows from the state-owned enterprises to the Government raises issues for the assessment of the fiscal position. There are reasons for thinking that these flows should be treated in the same way as privatization receipts would be. To the extent that a state-owned enterprise replaces debt owed to the Government with debt raised on the private market, other things being equal, there is no effect on the public sector's net worth. The flow of funds from the enterprise to the Government will be matched by a corresponding reduction in the potential market valuation of the enterprise concerned. In that connection, I note that the authorities are apparently open to the possibility of privatizing some of these enterprises in due course, although they will obviously wish to ensure that the transition from government department to free-standing corporation is successfully achieved first.

This issue leads me to the larger question of the fiscal position. The recent budget seems to have made an appropriate further step toward consolidating the fiscal position and thus reducing the pressures on the debt burden. As Mr. Rye notes, reducing the debt burden is a major priority for the authorities. In that connection, I did note that the recent refinancing of some of the external debt has led to a significant rise on both sides of the balance sheet to the extent that some of the latest borrowing has been used to augment reserves. It seemed to me that the staff report might have given greater emphasis to net debt service payments as opposed to gross interest flows. In any case, the clear need is to ensure that the growth in the debt burden is brought under control. Perhaps the staff could comment on the likely outlook for the debt/GDP ratio in the year ahead in light of the tightening of the fiscal position undertaken in the recent budget.

As the authorities recognize, continued efforts will be needed to strengthen the fiscal position in the years ahead. Although I accept Mr. Rye's point that much has already been achieved on the public expenditure front, it would clearly be desirable if further efforts could be made in this area given the rise in the tax burden in recent years. It is thus particularly encouraging to see that the authorities intend to ensure that welfare expenditure is more efficiently targeted.

In conclusion, the authorities have made very significant steps to improve efficiency and remove distortions within the economy. These efforts have already begun to show results and we would encourage the authorities to persevere.

Mr. van der Burg made the following statement:

It is with some envy that I look at economic developments in New Zealand. The structural reforms that are being implemented are comprehensive and radical by any standard. Financial policies, compared to last year, appear much improved, with a further tightening of fiscal policy, inflation rates declining from previously high levels, and some further improvement in the current account. The most impressive achievements to date are the labor market reforms and the realistic attitude reflected in the social partners' agreement to a very modest increase in nominal wages, and the acceptance of a rather sharp fall in real disposable income as indicated in Chart 4 of the staff report. Clearly, the basic policy advice one could give to the authorities is to continue on the path they have been following for the last three years. In what follows, I will comment on fiscal and on monetary and exchange rate policy.

First, on fiscal policy, I am impressed by the far-reaching structural changes that the authorities have been carrying out. The changes in the management of the public sector in particular, as well as the very thorough review of government spending, compare favorably with the across-the-board spending cuts often made by other industrial countries, and could, indeed, serve as an example. In this light, I was surprised by the staff's insistence on further emphasis on expenditure cuts, although, like the staff, I do underscore the need for fiscal consolidation. As Mr. Rye has noted, the authorities have already achieved much in this area, considering that expenditure as a percentage of GDP has been rather stable, notwithstanding a steep rise in interest payments on the public debt. In addition, public sector revenue, as a percentage of GDP, does not appear overly high compared to the OECD average. The staff could have given a somewhat firmer basis for its advice. I gather that the staff is primarily eyeing social spending and transfers, which at 60 percent of

total expenditures are a major component of spending that has not yet been addressed. The appointment of the Royal Commission seems a promising first step to reform in this area.

Undoubtedly, New Zealand will benefit greatly from the ultimate elimination of import tariffs, but I do sympathize with the authorities in arguing that the speed at which this is to be done must be balanced against the speed at which resources can be shifted. I wonder whether the authorities have an opinion on a timetable for the dismantling of import protection.

Turning to monetary and exchange rate policy, I welcome the liberalization measures that have been undertaken. Of particular interest are the changes in supervisory practices. The strategy of relying only on the flow of information to the public and to the monetary authorities, without compulsory asset ratios or liquidity requirements and deposit insurance, seems rather risky, especially now, when most authorities are increasing their supervision. Understandably, the conduct of monetary policy has been greatly complicated by the structural changes, and has been characterized by what seems to be a trial and error process, resulting in pronounced swings in interest rates and growth rates of some monetary variables. The sharp tightening of monetary policy in late 1986 was indeed warranted, in order to restore the credibility of the anti-inflationary stance. Nevertheless, I was somewhat puzzled and worried by the continuing high rate of growth of M3, as noted in the supplement to the staff report, particularly in light of the recent rapid fall of interest rates. Incidentally, I wonder whether the monetary authorities' credibility would not be helped by providing some goals for expectations, such as inflation targets. I recognize the difficulties this might entail, but to go entirely without such objectives, as is now the case, might well increase uncertainty.

Finally, the continuing appreciation of the New Zealand dollar is cause for concern, in view of the country's weak external position. While I share the authorities' view that a sustained improvement in competitiveness should be based on improvements in the underlying economic conditions, I believe that a less dogmatic stance on interventions may be helpful in this respect.

Mr. de Groote made the following statement:

Since I broadly agree with the staff's appraisal, I can confine myself to a single area of particular concern, the management of a public debt of considerable magnitude. A particular reason for me to focus on this topic is that, despite a few substantial differences, New Zealand's situation displays on this point some interesting similarities to that of Belgium.

New Zealand is one of the many countries whose situation is seriously threatened by the debt/interest trap. The least one can say without becoming dramatic is that a public debt approaching 72 percent of GDP and interest payments absorbing almost a quarter of total tax revenues raise serious questions about the sustainability of the situation. High interest payments are, of course, the main obstacle to the stabilization of the debt.

In addition to the snowballing effect of the debt service, the authorities face a heavy foreign exchange risk since most of their public debt is denominated in foreign currencies that happen to be strong at present: 28 percent in yen, 10 percent in Swiss francs, 8.5 percent in pounds sterling, and 6.5 percent in deutsche mark. The authorities therefore confront a dilemma: the exchange rate adjustment which is needed to stimulate exports and sustain the external adjustment will simultaneously increase the public debt. This dilemma supports the notion that it might have been preferable to accumulate domestic rather than foreign debt. The Belgian authorities have thus adopted the view that it is easier, especially for small countries, to grapple with domestic than with foreign debt, because so many aspects of foreign debt policy lie beyond a country's control.

One of the options open to the authorities in the present circumstances is to use their large capital inflows resulting from the positive interest differential to convert their foreign currency debt into domestic currency debt, instead of allowing the exchange rate to appreciate in response to demand. This would also make external adjustment much easier than if a currency appreciation refuels consumption and sends the wrong signals to the export industry sector.

Once the foreign debt has been reduced through a shift to domestic liabilities, the authorities might be in a position to implement a more finely tuned debt management policy without incurring the risk that their actions would be canceled by exogenous factors. The basic instrument to be used would, of course, be fiscal policy, especially in the form of expenditure reduction. Here we are especially reassured by the fact that the budget deficit outcome has been more favorable than initially expected.

Two other important instruments, which have been used to good effect in the debt policy of the Belgian authorities, are monetary and interest rate maneuvers. The Belgian Government has saved substantial amounts by the fine-tuned maintenance of long-term interest rates at levels which are relatively low compared to high short-term interest rates. There can be no doubt, however, that the confidence of the economic agents is the main precondition for the success of such an approach.

Mr. Rye's introductory statement and the staff's supplementary paper both seem to confirm that confidence has been restored. This gives the authorities a unique opportunity to reduce the risk premium which became embedded in domestic interest rates owing to the large swings in monetary policy, which have not only undermined the authorities' credibility but also triggered inflationary expectations.

Mr. Yamazaki made the following statement:

It is encouraging that corrective reform measures have continued to be taken both in macropolicy areas and in structural areas in the past year. The GST was introduced and the corporatization of public enterprises has continued. Tariffs have been cut in a move toward import liberalization. The fiscal deficit has been reduced and the external deficit has decreased. The moderate wage settlements by the authorities were most notable. Realistic wage settlements are necessary in order to ease the pressure of inflation as well as to restore international competitiveness, and I therefore commend the authorities for the development in this respect.

There have also been adverse developments, such as the moderate decline in the GDP growth rate. However, as the authorities recognize, the fruit of the reforms will emerge only in the long term, and in the short run, they can be expected to have some adverse impact. Since in the past short-sighted demand-management policy has exacerbated the economic situation, the current momentum of reform should be maintained despite some unfavorable economic indicators.

As I am broadly in agreement with the staff appraisal, let me comment on specific policy issues.

Although many positive developments have occurred on the fiscal front, my chief concern is still in this area. It is true that the budget deficit in 1986/87 has been further contained through the tax reform and the expenditure cut with a comprehensive scrutiny of expenditures. However, at the same time, the ratio of government debt to GDP rose to 85.7 percent. The accumulated debt is now having an adverse effect on the exchange rate and interest rates, and interest payments on the debt constitute a large share of budget expenditure. In order to reduce the government debt/GDP ratio and thus ease the adverse pressure on the exchange and interest rates, further efforts to contain the budget deficit should be made. In this connection, I welcome the fact that further improvement is expected in the next budget, but even more emphasis on expenditure controls might be appropriate.

Monetary policy should be used to reduce the pressure of inflation. Even if we take into account the impact of the introduction of the GST, the growth rates of both consumer prices and domestic credit are rather high. Thus, a tight policy stance should be continued in order to close the inflation gap between New Zealand and its trading partners.

I welcome the authorities' recent efforts to promote a Training Assistance Program and a Job Opportunities Scheme, which put more emphasis on training than on subsidies. However, in order to increase competitive pressures on the labor market, further flexibility of bargaining structures and labor market institutions is required. I hope the new Labor Relations Bill and the proposed legislation on the reform of labor relations in the public sector will serve this purpose.

I welcome the further decline in the current account deficit, but in light of the current high external debt associated with the growing debt interest payments, efforts should be made to further cut the external deficit. In this connection, the improvement of competitiveness in the export sector through further structural reforms and import liberalization measures is necessary, as is prudent debt management, in order to mitigate the current debt situation.

Mrs. Hepp made the following statement:

Since mid-1984, New Zealand's authorities have been implementing a series of structural reforms as a response to the stagnation that had characterized the economy in the years before. We welcome this new approach intended to achieve significant changes in the economy in the medium term, with strong reliance on market forces and the more direct exposure of economic agents in the country to external variables and influences.

The structural measures just implemented in the labor market and public sector and trade policy are especially commendable. During the past year, further steps have been taken in these fields to liberalize the goods and labor markets and increase their flexibility. We wish to highlight here the moderation of wage settlements during the last wage round, in an environment of free and serious bargaining, as explained in the staff report. Also welcome is the conversion of a number of government entities into corporate structures, thereby improving the organization and management of the public sector. Especially significant are the steps to liberalize imports, and the reduction of assistance to the export sector, which contrasts with the trend abroad toward protectionism and subsidies.

The deep structural changes implemented have had an inevitable cost in the short run during the adjustment process, in terms of stability and growth. However, it is reassuring to note from Mr. Rye's statement that recent economic trends show these costs and the length of the adjustment process will be much lower than expected.

On fiscal policy, we welcome the important tax reform just implemented. Our concern is with the high public debt, which amounted to 72 percent of GDP in March 1986. The servicing of this debt is a heavy load on the budget, so further efforts in improving the fiscal situation are needed. We agree with the staff that this should be done by reducing expenditures.

We are somewhat concerned about the pronounced swings that occurred in the monetary conditions during the past year. We believe that a close monitoring of monetary policy could be made easier by establishing clear targets--for monetary aggregates or inflation--to be achieved during the year. This would help to clarify the uncertainties or expectations in the short run. In contrast, we welcome the supervisory legislation recently approved, and the smooth adjustment of the financial sector to the new conditions.

On exchange rate policy, we share the concerns of the staff about the real effective appreciation of the national currency. The view that the current account, and the debt and debt service ratios would improve substantially in the medium term with the assumption of a modest real effective exchange rate depreciation is valuable advice that the authorities should take into account. However, we also share the view of the staff and the authorities that this must be achieved as a result of a consistent set of policies, and not by isolated interventions in the exchange rate market.

To conclude, we believe that the New Zealand authorities have been implementing an impressive reform program, and we commend them for their advances in that direction. However, we encourage them to consider the staff's recommendations, particularly on public sector finances, as the basis on which to improve the performance of the economy.

The staff representative from the European Department noted that it would have been difficult for the authorities to have given much weight to theoretical considerations in deciding on the sequence of reforms. At the time when the reform program was initiated there had been little, if any, support for deregulation in the more rigid markets, which according to the academic literature should be the first ones to be liberalized. By contrast, there had been considerable support for deregulation of the financial sector because the costs of existing controls had become quite

apparent. Moreover, the authorities had to keep in mind the constraints on the pace of reforms implicit in New Zealand's short political cycle and the fact that the very large budget deficit that they had inherited would take time to be eliminated. While early liberalization of the goods and labor markets would have been desirable, the need for such liberalization had become more widely recognized only in the wake of financial deregulation which had helped to make the costs of rigidities in these markets more transparent.

The authorities' approach to monetary policy was not entirely judgmental or eclectic, the staff representative commented. The authorities had specific and publicly announced targets for "primary liquidity," which was a version of the monetary base. Their objective at present was to maintain primary liquidity broadly constant over the course of the financial year. But, at the same time, the authorities had learned from experience that discretionary adjustments in the targeted level of primary liquidity might be needed from time to time to compensate for shifts in the demand for liquidity. Such adjustments were decided on the basis of a review and analysis of all available indicators of monetary conditions.

A basic premise of the authorities' approach to monetary control was that there existed a stable underlying relationship between primary liquidity and lending by financial institutions, the staff representative observed. Experience to date cast considerable doubt on the validity of that premise. For a while the substantial variability in the relationship between primary liquidity and bank lending could be explained away as a consequence of financial deregulation and innovation. However, as time went by that explanation became less convincing. Consideration should be given to introducing cash reserve requirements, or some such instrument, to help impart greater stability in the relationship between primary liquidity and the broad aggregates.

The policy of fully funding the budget deficit and other injections of liquidity by the public sector, in combination with the fact that the authorities did not intervene in the foreign exchange market on a systematic basis, appeared, in general, to be sufficient to ensure no trend growth in primary liquidity, the staff representative explained. There were, of course, substantial fluctuations in primary liquidity in the short run related to seasonality in the fiscal accounts and/or forecasting errors by the authorities.

One of the more difficult policy issues confronting the authorities was the conflict in the short term between the objectives of promoting a lower rate of inflation, and of maintaining external competitiveness at a satisfactory level, the staff representative remarked. As some Directors had indicated, there might be room for alleviating that conflict through official intervention in the foreign exchange market or by allowing part of the budget deficit to be financed through foreign borrowing. However, the authorities and the staff shared the view that the room for such action was limited. In the final analysis, substantial intervention in the foreign exchange market or official borrowing abroad would be tantamount to

an easing of the authorities' monetary policy stance which in present circumstances would be inappropriate. In the staff report, the emphasis was placed on fiscal adjustment and on further import liberalization, because those apeared to be the more promising ways in which the conflict between the two objectives could be diminished.

Turning to fiscal policy, the staff representative acknowledged that the authorities had made substantial progress in containing public expenditure, although the benefits of their efforts had been masked to some extent by the growth in debt interest payments. Nevertheless, the authorities and the staff agreed that there was room for further expenditure restraint, particularly in social spending. The public debt/GDP ratio was likely to fall somewhat in the current year, and the external part of the debt might fall even in absolute terms. It was worth mentioning in this respect that the authorities had indicated in the recent budget that they intended to repay some foreign debt in the course of the current year.

It was true that the tax system was not insulated from the effects of changes in inflation, the staff representative said. The difficult question of whether tax should be imposed on nominal incomes or real incomes had received some attention in New Zealand. While issues related to the tax treatment of interest payments were under study, a capital gains tax was not currently envisaged. More generally, the authorities had not committed themselves to indexing the income tax system. The estimates of the direct impact of the 1986 tax reform on tax revenues had not proven far off the mark. However, the introduction of the GST had had the unexpected side effect of improving compliance with the income tax code and thus had contributed to the unexpected buoyancy of total tax revenue in the last few months of 1986/87.

The observations made by Mr. Ebrill on state-owned enterprises were well taken, the staff representative remarked. The authorities recognized that the threat of competition may not in itself be sufficient to ensure efficient pricing by state-owned enterprises, particularly in situations where a natural monopoly existed and where entry costs were high. Accordingly, they accepted the need to put in place an appropriate regulatory framework.

Questions could be raised about the authorities' approach to prudential supervision, the staff representative noted. For instance, would monitoring and consultation with the financial institutions enable the authorities to detect emerging difficulties quickly enough? Would the institutions and the public at large believe that the authorities could afford to allow an institution to fail? These questions were not easy to answer and, as yet, there had been no test of the authorities' preparedness to allow an institution to fail.

On the reform of the labor market, a number of Directors had referred to the minimum membership requirement imposed for the setting up of new unions, the staff representative noted. The reservations expressed in the staff report on that issue were primarily related to whether the

restriction was compatible with the desire of the authorities to replace a proscriptive system with a permissive one. The staff had no strong views as to whether large or small unions were preferable in the New Zealand context. Currently, there was a large number of unions, and perhaps one of the advantages of the restriction would be to promote amalgamation. The disadvantage was that the restriction would make it more difficult for competing unions to emerge.

The balance of payments forecasts in the staff report were already out of date, the staff representative indicated. The reduction in the fiscal deficit budgeted for 1987/88, together with the recent firming of some commodity prices that were of importance to New Zealand, justified a significant downward revision of the external current account deficit forecast for the current year. The staff had revised its forecast downward in the context of the world economic outlook at a level very close to the revised official forecast mentioned in Mr. Rye's statement. For 1988/89, the staff was still rather less optimistic than the authorities, but it agreed with Mr. Rye that the base scenario outlined in Table 5 of the staff report was now out of date.

Statistics on external debt did not include obligations denominated in New Zealand dollars, and by implication, obligations to nonresidents by New Zealand's financial institutions were not taken into account, the staff representative explained. The staff agreed with Mr. King that the net debt/service ratio might be a more appropriate indicator of the debt service burden at present, in view of the recent sharp increase in official reserves which was intended to be temporary.

The external debt of public corporations which the Government had taken over had enjoyed either explicit or implicit government guarantees, the staff representative from the European Department concluded. This debt had become unserviceable owing in part to adverse developments in energy prices. While in some cases it might have been possible for the corporations to continue to service this debt by raising the prices charged for the services they provided to the community, the authorities felt that such a course of action would have been inconsistent with their objective to promote increased efficiency in the state-owned enterprises and would have penalized unfairly users of these services.

The Acting Chairman recalled that Mr. Rye had asked whether medium-term scenarios were useful in a country like New Zealand, which faced a volatile external environment. Surely, the fact that the external environment might be volatile in the medium term was important information for a government to take into account in managing its external debt and reserve management policies.

Mr. Rye said that he agreed with the Acting Chairman. Nevertheless, he wondered whether the great efforts devoted to quantitative as opposed to qualitative assessment were always worthwhile, especially as the results were sometimes misleading.

If the slowdown in growth and other problems in the New Zealand economy were essentially due to the uneven pace of liberalization and reform, as Mr. Ismael had suggested, Mr. Rye continued, it was probably in part because of the inevitable constraints faced by any government. Certainly, the authorities had adopted the correct policy by pushing ahead as quickly as possible in the areas where that was possible. In the process, the barriers in other areas had begun to fall away. For example, in the labor market, a labor or social democratic government faced severe constraints, particularly in a country like New Zealand where the union movement had long been powerful in politics and economics. The costs and dislocations of reform in New Zealand reflected to a large extent the magnitude of previous distortions resulting from decades of massive interference with market forces.

On fiscal policy, it would perhaps be accurate to characterize the outcome in 1986/87 as one of substantial underlying improvement masked by cyclical developments and trends in inflation, Mr. Rye considered. The purpose of the table in his opening statement had been to show--with the necessary qualifications that must be attached to such figuring--that from that point of view, the bottom line of the budget had really improved by approximately 2 percent of GDP. The improvement was not insignificant, and was expected to increase in 1987/88. As to the question whether a further improvement would exacerbate the upward pressure on the exchange rate, it appeared more likely that without fiscal improvement, it would be difficult to achieve a better balance of policies, with reduced pressure on monetary policy, lower interest rates, and all the resulting benefits.

There had been considerable fluctuations in monetary policy over the last year, and the authorities would agree that they should aim at a more predictable and smooth policy path, Mr. Rye said.

A number of Directors' comments implied that they would have liked to see a more active use of exchange rate policy, Mr. Rye observed. As far as he knew, New Zealand's float was as free as that of any country, which was all the more remarkable in such a small economy. However, the authorities were very much conditioned by earlier disastrous efforts to sustain unsustainable exchange rates in the face of market opinion to the contrary. They felt that it would be a long time before the credibility of intervention in exchange markets would be restored; in the meantime, they preferred not to run further risks.

On the related question of overseas borrowing, authorities had carefully considered whether they should adopt a more active policy of foreign borrowing to cover the fiscal deficit, Mr. Rye said. However, they had concluded that they should substitute domestic debt for foreign debt, for the reasons mentioned by Mr. de Groote.

There had been some differences of opinion on the validity or usefulness of the measures introduced by the Government in the labor market, Mr. Rye commented. Labor policy was of course an evolutionary process.

rather general formulation of the questionnaire, both of which call for a great deal of caution in drawing firm and far-reaching conclusions. In any case, even if the only outcome of this exercise were an increased awareness about the already existing characteristics of the SDR and a move by some members to assign a greater role to the SDR in their reserve management practice, the study would already have served its purpose.

The study's finding that the SDR is not given high priority in members' reserve management decisions does not come as a surprise. Nevertheless, the responses to the questionnaire are interesting as they do have a bearing on the credibility of the arguments in favor of further allocations. Since SDRs constitute only a small fraction of total reserves, it would seem only natural that monetary authorities generally concentrate their attention on other reserve assets. It would be unjustified, however, to turn this argument around and conclude that an increase in the supply of SDRs would by itself make the SDR more attractive (page 5, footnote 2). Indeed, as the staff points out, it is by no means clear that additional allocations of SDRs would, by themselves, increase the desired average holdings of SDRs (page 18).

A large proportion of the members responding to the questionnaire view the SDR's stable value and safety as the most attractive features, whereas its limited liquidity and usability are considered the most important disadvantages of the SDR. I must admit that I found the argument that the SDR is not sufficiently liquid and usable rather unconvincing. It fails to recognize the specific role and purpose of the SDR, namely, to provide additional reserve liquidity in case of a (short-term) balance of payments need. This implies that, ideally, the stock of SDRs held by member countries should fluctuate around the level of their cumulative allocations. However, the widespread practice of exchanging SDRs received for "more attractive" reserve assets and acquiring SDRs only shortly before payments become due to the Fund would suggest that many members consider the SDR as a permanent "lowest cost source of credit" (page 8). This practice only tends to confirm the arguments of those who reject the use of the SDR as an instrument for the transfer of resources.

From the responses to the questionnaire one cannot help but get the impression that some members are not sufficiently aware of the advantages of holding a certain stock of SDRs. It is hard to reconcile the frequently assumed lack of liquidity and usability of the SDR with the fact that under Article XIX, Section 2(b) any member may use its SDRs to obtain an equivalent amount of currency from another participant. In fact, Article XIX permits the use of SDRs for all the transactions that can normally be expected in the context of members' reserve management practices, and without demonstrating a balance of payments need.

Directors recognized that the conduct of monetary policy in 1986 and 1987 had been overburdened owing to the high fiscal deficit and complicated by distortions in the pattern of private sector spending associated with the introduction of the tax on goods and services as well as by continuing unpredictable shifts in the demand for liquid balances by the financial sector. Nevertheless, Directors expressed concern about the continued rapid growth of monetary aggregates and underlined the need for monetary policy to be cautious, particularly in the light of the rate of inflation. In addition, some Directors raised questions about whether the relatively volatile monetary conditions over the past year suggested the need to review present methods of monetary policy implementation.

The external current account deficit was still high, Directors felt, especially if seen in the context of New Zealand's large external debt and the recent weakness of domestic demand. They therefore viewed with some concern the weakening of competitiveness and the appreciation of the New Zealand dollar in the recent past. Directors generally agreed with the authorities that increased fiscal and wage restraint was essential in order to help lower inflation, ease upward pressures on interest rates, and achieve a lasting improvement in competitiveness and the external current account position. Several Directors also suggested that an acceleration in the pace of import liberalization could assist in alleviating domestic cost inflation and strengthening the competitive position of the export sector. At the same time, protectionist tendencies in New Zealand's main export markets were deplored.

Finally, several Directors welcomed the improvement in the fiscal position and considered that this should assist management of other aspects of economic policy, especially monetary policy. They suggested that these trends plus needed improvement in macroeconomic indicators and further progress on structural reforms could lay the basis for sustained growth in the future.

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

3. SDR IN RESERVE MANAGEMENT PRACTICES OF MONETARY AUTHORITIES

The Executive Directors considered a staff paper on the SDR in the reserve management practices of monetary authorities (SM/87/72, 3/17/87).

Mr. Grosche made the following statement:

I welcome this staff study which follows up on a request by the Interim Committee. The study is quite helpful despite the limited number of members participating in the survey and the

transactions transparent. For this reason and also to ensure that the Executive Board can properly monitor the operations of the SDR Department, detailed and timely information is essential.

I am prepared, however, to look into the possibility of requiring instructions only from the holder transferring SDRs. By the way, the argument that present requirements are cumbersome because communications read more like legal documents than payment instructions is not very convincing, as those documents are standardized texts prepared and provided by the Fund.

I have no objections to a possible widening of the SDR market if that means member countries enter on a voluntary basis into agreements to buy and sell SDRs. It would, however, run counter to the principles of the system if such arrangements were to create incentives for members to circumvent the designation process by buying SDRs at a lower rate through two-way arrangements. I also cannot support the suggestion "that the Fund itself could move in a direction that would make more market-like arrangements for the SDR" (page 25) be it in the form of a pool or in the form of transactions through the General Resources Account. The Fund's financial transactions and operations are to support the international adjustment process; market making does not fall under the Fund's responsibilities. The Fund should also not take over the role of a "buyer of last resort" for SDRs held by other holders (page 26). I see the danger here of allocated SDRs being channeled back to the Fund (and "dumped" in its accounts) via other holders.

2. Usability

Enlarging the number of prescribed holders would pose no problems as long as they are official institutions with a justified interest in participating the SDR system. The proposal to allow accounts in the SDR Department for private sector institutions, however, is not welcome. First, because it is not permitted under the Articles of Agreements--and I see no need to change or amend them. Second, because I do not consider it appropriate to further broaden the scope of the SDR as a general "means of payment." The same would apply to the establishment of links between transactions in official and private SDRs.

On simplifying SDR transactions and operations I have an open mind regarding specific improvement, but I can only support proposals to extend the catalogue of permitted transactions. I cannot go along with plans to replace the catalogue with one single authorization to engage in any transactions.

I thus share the view of the staff (page 22) that, even in its present form, the SDR may have the potential to become a more important reserve asset than indicated in the responses to the questionnaire.

A great deal of caution is called for when contemplating changes for the SDR. As the staff points out, some of the possible changes explored in Section IV of the paper could have significant operational consequences for the Fund. While I am prepared to consider some of the specific proposals, none of the alleged shortcomings of the SDR appear significant enough to justify changes or amendments to the Articles of Agreement.

The SDR has to remain a purely monetary instrument. It is quite well equipped to fulfill its role of supplementing international liquidity in case of a long-term global need and to serve as a "buffer" for short-term fluctuations in members' balances of payments:

- its stability and safety make the SDR well suited to serve the precautionary and investment functions associated with holding reserves;

- its liquidity and usability are guaranteed in case of a balance of payments need and for all transactions by agreement that normally occur.

Thus, from the point of view of ensuring the effective role of the SDR as a reserve instrument, it is not necessary to move it further in the direction of serving the transaction functions associated with other reserve assets. In any case, SDRs can easily be converted into freely usable currencies if the need for supplementing readily available "working balances" in members' reserves should arise. There are certainly some avenues that can be explored to enhance the attractiveness of the SDR as a reserve asset, but such efforts should be kept within the principles and guidelines of the Articles of Agreement.

This brings me to the more specific proposals put forward in Section IV of the staff paper:

1. Liquidity

I have no objections against seeking ways to reduce transaction costs by reducing the time involved in SDR transactions. However, concerning the reduction of reporting requirements, it is important to bear in mind--also in the context of the complaints by some members about the "inadequate confidentiality" (page 27)--that the SDR system places certain obligations on third parties through the designation procedure, and that therefore all participants have a justified interest in keeping SDR

I agree with the staff that some efforts might be considered to increase member awareness of the advantage of holding SDRs to cover SDR-denomimated liabilities--through the IMF Institute, for example--however, I do not see that a significant change can be obtained through these efforts, since most countries that are indebted to the Fund tend to use their holdings of SDRs to finance their large current account deficits, or to service their obligations to the Fund, or both.

The major disadvantages of holding SDRs are their low liquidity and limited usability. These unfavorable characteristics are associated with another function of reserves: transaction purposes. Since this function is an indispensable part of the purposes of holding reserves, the deficiencies of the SDR in relation to liquidity and usability will have to be adequately addressed, and I support the staff's proposals in these regards, proposals that include a reduction of the time and procedures involved in SDR transfers; widening of the SDR market through an increase in the number of member countries that buy and sell SDRs; the establishment by the Fund of a pool of SDRs and freely usable currencies, and an increase of the number of authorized holders; and the simplification of SDR transactions and operations.

Mr. Salehkhou made the following statement:

Based on the recommendations of the Interim Committee, the Executive Board has, over a number of years, examined the merits of the SDR with a view to improving the attractiveness of this reserve asset. The staff paper before us constitutes a further attempt to explore possible improvements.

Notwithstanding the limited number of members canvassed, the survey's findings are more or less similar to the views already expressed by most Directors on various occasions. The staff conclusions are generally convincing, and efforts to explore potential avenues for enhancing the role of the SDR as a reserve asset seem appropriate. I agree with the staff that a further survey with an expanded sample would enrich the results across different country groupings. This raises the question as to whether, and to what extent, these findings and the prospective enhancement of the role of the SDR could lead to a new allocation in the absence of political support from a few major industrial countries.

The Executive Board and the staff have both spent more than enough time and resources on the SDR issue. I recognize the important role that the SDR can and should play as principal reserve asset, but the allocation of SDRs is currently more a political issue than a technical or economic one. Disappointingly, the share of SDRs in total international reserves has continued to decline in the absence of new allocations, despite considerable

3. Reserve management issues

As mentioned before, the SDR is already quite well suited to serve the precautionary and investment functions associated with holding reserves. I therefore support attempts on the part of the Fund to increase the awareness of the potential advantages of holding SDRs among members. It would be very welcome if more of the Fund's debtors could be convinced that by increasing their holdings of SDRs they could cover at least part of their exchange risk in connection with obligations falling due. This would not only have advantages for the members in the context of making payments to the Fund, it would also bring up the ratios of members' SDR holdings relative to the amounts allocated to them.

Mr. J. E. Ismael made the following statement:

I welcome today's discussion on the SDR in the reserve management practices of monetary authorities. The staff paper before us provides a clear picture of both the existing and the potential roles of the SDR in reserve management; it also outlines some possible avenues that can be explored to enhance the role of the SDR in the future.

I am in general agreement with the analysis contained in the paper. In particular, I agree that compared with other reserve assets, the SDR has some advantages--in stability, safety, and payments to the Fund--as well as disadvantages--mainly in liquidity and usability. A significant improvement in the role of the SDR in reserve management can be achieved through a better utilization of the existing advantages, coupled with the removal of substantial disadvantages.

As noted by the staff, the most favorable characteristics of the SDR are its stable value and safety, which mean that holding SDRs can reduce the risk of capital losses stemming from exchange rate fluctuations. Moreover, the default risk of the SDR--the risk of not receiving usable currencies in exchange for SDRs or not receiving interest due on SDRs held above allocations--is also relatively low. These characteristics made the SDR suitable for the longer-run precautionary and investment purposes associated with holding reserves. Since many countries, especially those with relatively high reserves, hold a large part of their reserves for these purposes, ample room is available for a significant increase in the SDR's share of total reserves. For that objective to be achieved, however, the total amount of SDRs in circulation should be substantially increased, so as to accommodate the need of member countries: a sufficient allocation of SDRs will contribute to the attainment of that objective.

Taking into account the importance attached to the SDRs in the Articles of Agreement, further improvement in the characteristics and the functions of the SDRs is well worth exploring. All possible avenues should be carefully explored, and amendments to the Articles of Agreement should not be ruled out, if these become necessary. Transaction costs should be lowered, and the market for SDRs widened, in line with the staff's recommendations for reducing the time and "red tape" involved in SDR transfers, and for the participation either of member countries, or the Fund itself, in market-making activities. The Fund's participation in the market would enhance the SDR's liquidity, and might also help the Fund to monitor the exchange and interest rates of major reserve currencies more precisely, thus permitting the Fund to make more timely recommendations to the authorities concerned. Improved monitoring would also enable the Fund to make appropriate changes in SDR interest rates when the demand for SDRs fluctuates, increasing the desirability of the SDR as an important reserve asset, while helping the Fund to promote exchange rate stability.

Other possible ways to enhance the usability of SDRs include the enlargement of the number and types of permitted transactions. I fully support the staff's view that countries with liabilities to the Fund might advantageously hold a portion of their reserves in SDRs so as to make timely repurchases directly to the Fund without the involvement of private financial intermediaries. It therefore seems desirable that the staff also explore other possible avenues for enhancing the scope of SDR transactions between members and prescribed holders. For example, one possibility could be the use of SDR holdings by members as a means of making repayments to the World Bank Group. This would help to eliminate private commercial intermediaries, whose involvement is generally costly, while often involving undue delays in both the effective transfer of members' payments and in reporting such transfer payments to the World Bank. Two members of my constituency have occasionally suffered the adverse consequences of such tardy--or even commercially or politically motivated--actions on the part of the commercial intermediaries, leading to their unjustified listing among those with overdue financial obligations to the World Bank. Perhaps the staff would examine this proposal carefully, especially in light of the large size of payment transactions between members and the World Bank Group.

Increasing the number of prescribed holders and permitting private sector financial institutions to acquire, hold, and use SDRs would broaden its scope and function. I have an open mind on this issue and welcome substantive Board consideration of it. I also see some logic in simplifying SDR transactions and operations, and any possible reduction in conditions and restrictions is worth exploring.

staff efforts to enhance its liquidity and usability, and despite its favorable characteristics regarding safety and stability. It is, therefore, not surprising that nearly all respondents indicated that they do not give high priority to the SDR in their reserve-management decisions.

I will first make some general comments on the advantages of holding SDRs, and I will then elaborate on the disadvantages, and on the staff's proposals to reduce its shortcomings.

As the staff noted, safety and stability are the most desirable characteristics of the SDR. For countries that accumulate a high level of reserves, the portion beyond that required for immediate transaction purposes would generally be allocated for investment objectives. Yield and default and exchange risk considerations are generally the most important factors influencing monetary authorities' decisions on these longer-term reserve asset investments. In this case, the SDR, as a basket of currencies whose value is safer and more stable than alternative reserve currencies, is well suited to serving the investment function associated with holding reserves. Furthermore, the immediate availability of the SDR in the case of balance of payments need has given rise to its important function as a shock absorber. The SDR may also be held for institutional requirements.

Given the survey findings, increased Fund member awareness of these advantages could be emphasized in some IMF Institute courses. Such awareness could profitably be imparted directly to those officials responsible for reserve management, as not all Institute participants are from monetary institutions or are directly involved in the process of currency-related decision making. Perhaps the participation of relevant officials from member countries in special seminars held or sponsored by the Institute would be appropriate; staff recommendations to the authorities during the course of Article IV consultations could also serve this purpose.

The most important disadvantages of the SDR appear to be its limited liquidity and usability compared to other reserve assets. By standard banking definitions and practices, a reserve currency should be flexible in use and easily transferable into other currencies or means of payment at short notice. Apart from the payment of obligations to the Fund, the use of the SDR has been subjected to balance of payments need, or transactions by agreement. SDR usability is also limited, as it cannot be used directly as traded currency, nor is it usable for intervention purposes. These disadvantages, together with the formal mechanism and requirements that govern SDR use--such as regulations governing reporting and the need to characterize each use in a form authorized by the Fund--have made the SDR less attractive to potential holders.

I note, however, that the staff intends to undertake a further study that will include the reserve currency countries. To this end, the questionnaire should be revised to focus on more direct questions related to the future role of the SDR in the system and on any modifications that may be necessary. In other words, the last subquestion of question 3 should be expanded.

Turning now to the possible avenues identified in Section IV of the staff paper, I will touch upon the liquidity and usability of the SDR and on the reserve management issues raised in paragraph 3.

The survey indicates that the SDR's liquidity and usability need to be improved. The staff suggests two ways of increasing liquidity: lowering transaction costs and widening the market for SDRs. Since the marginal cost of using SDRs is zero, efforts to reduce transaction costs should center primarily on reducing transaction time and some of the reporting requirements, the "red tape." It is therefore worth exploring the possibility of requiring instructions only from the holder transferring SDRs. In addition, a declaration from one party as to the conformity of an intended SDR transaction with the appropriate prescription should suffice.

Concerning the widening of the market for SDRs, we have no difficulty with the idea of having member countries engaging in market-making activities. However, the staff has noted the various limitations that hamper the expansion of such market-making activities, and it therefore seems worth exploring an enlargement of the number of both authorized holders and the types of transactions for which SDRs can be used. Little progress can be made on an increase in the number of prescribed holders without the inclusion of private sector entities. That would, however, require amendment of the Articles of Agreement--which would be warranted if the SDR is in fact to become the principal reserve asset in the international monetary system, as the Articles of Agreement specify. We accept the staff's suggestion to replace the series of Board decisions authorizing specific operations in SDRs by a single authorization for all participants and prescribed holders to engage in any transaction or operation by mutual agreement, subject to the relevant limitations imposed by the Articles.

We see merit in the Fund's efforts to increase member countries' awareness of the potential advantages of holding SDRs, particularly for countries with liabilities to the Fund. We agree that the IMF Institute should emphasize the advantages of the SDR during its courses.

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

All avenues suggested by the staff to make the SDR more attractive deserve full support. However, these changes will be effective only if the stock of SDRs in relation to actual international reserves is raised substantially by new allocations, which would let the SDR fulfill its function as a principal reserve asset.

Mr. Toé made the following statement:

This chair welcomes the staff study on the role of the SDR in the reserve management practices of monetary authorities, because it gives further evidence of the need to enhance the reserve asset potential of the SDR, so that it can play a meaningful role in the international monetary system. According to the study, industrial and developing countries alike consider the SDR to be a relatively unimportant reserve asset, and one that is not given high priority in their reserve management decisions. Of the various explanations supporting this view given by survey respondents, two seem the most important: the relatively low liquidity and usability of the SDR; and its limited quantity relative to other reserve assets. Put differently, the study suggests that the SDR would be treated differently in the reserve management decisions of most respondents should its liquidity and usability be enhanced and should its relative share in aggregate reserves be increased.

As we stated during previous discussions on the SDR, it is critically important that the quantitative and qualitative aspects of the SDR be dealt with simultaneously in enhancing its role in the international monetary system. The survey findings reinforce this view, and we find it difficult to resist drawing the conclusion--also drawn by the staff--that if additional SDRs were allocated in substantial amounts so as to increase the SDR's share in aggregate reserve assets, countries would devote more attention to it in their reserve management decisions. Of course, as the staff also notes, it is not clear whether an increase in the supply of SDRs would by itself increase the demand to hold SDRs. However, it is likely that an increase in the supply of SDRs combined with an enhancement of their liquidity and usability might lead to increased demand for them.

While I understand the rationale behind the staff's approach in the selection of the countries, it would have been interesting to include the five reserve currency countries in the sample. That would have permitted a direct comparison of the reserve management practices of reserve currency countries with those of nonreserve currency countries, and would also have shed some light on reserve currency countries' views on the SDR. It may not be incidental that all but one of these countries have so far expressed their opposition to the resumption of SDR allocations.

6. ZAMBIA - OVERDUE FINANCIAL OBLIGATIONS - REPORT AND COMPLAINT UNDER RULE S-1, AND NOTICE OF FAILURE TO SETTLE TRUST FUND OBLIGATIONS

1. The complaint of the Managing Director regarding Zambia's overdue obligation in the SDR Department and the notice of failure to settle Trust Fund obligations dated July 2, 1987, in EBS/87/146, are noted. They shall be placed on the agenda of the Executive Board for August 3, 1987. If at that time Zambia is not current in its obligation to pay charges in the SDR Department, the Fund will consider suspending the right of Zambia to use SDRs it acquires after the suspension pursuant to Article XXIII, Section 2(b), other than for settlement of financial obligations to the Fund.

2. The Fund urges Zambia to become current in its financial obligations to the Fund promptly and to avoid thereby the need for the Fund to take remedial action.

3. Consideration of the complaint in accordance with Rule S-1 and Trust Fund notice particularly affects Zambia. The member shall be informed by rapid means of communication of this matter and of its right to present its views through an appropriately authorized representative.

Decision No. 8639-(87/101) S/TR, adopted July 8, 1987

7. SDRs - USE AS MEDIUM OF PAYMENT FOR TRUST FUND OBLIGATIONS

a. Medium of Payment of Trust Fund Interest and Repayment of Principal

1. Decision No. 6358-(79/188) TR, adopted December 19, 1979, shall be amended by the addition of the following sentence:

Such payments may be made also in SDRs in accordance with Decision No. 8642-(87/101) S/TR, adopted July 9, 1987.

2. Decision No. 7142-(82/85) TR, adopted June 18, 1982, shall be amended by the addition of the following sentence:

Such repayment may be made also in SDRs in accordance with Decision No. 8642-(87/101) S/TR, adopted July 9, 1987. (EBS/87/149, 7/6/87)

Decision No. 8640-(87/101) S/TR, adopted July 9, 1987

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/87/100 (7/8/87) and EBM/87/101 (7/10/87).

4. TANZANIA - STAND-BY ARRANGEMENT - WAIVER OF PERFORMANCE CRITERION

The Fund decides that Tanzania may, notwithstanding paragraph 4(a) of the stand-by arrangement for Tanzania (EBS/86/183, Sup. 1, 8/29/86), proceed to make purchases under the arrangement. (EBS/87/151, 7/6/87)

Decision No. 8637-(87/101), adopted
July 9, 1987

5. SIERRA LEONE - OVERDUE FINANCIAL OBLIGATIONS - REPORT AND COMPLAINT UNDER RULE S-1, AND NOTICE OF FAILURE TO SETTLE TRUST FUND OBLIGATIONS

1. The complaint of the Managing Director regarding Sierra Leone's overdue obligation in the SDR Department and the notice of failure to settle Trust Fund obligations dated July 2, 1987, in EBS/87/145, are noted. They shall be placed on the agenda of the Executive Board on July 17, 1987, the same date as the review of Decision No. 8566-(87/61). If at that time Sierra Leone is not current in its obligation to pay charges in the SDR Department, the Fund will consider suspending the right of Sierra Leone to use SDRs it acquires after the suspension pursuant to Article XXIII, Section 2(b), other than for settlement of financial obligations to the Fund.

2. The Fund urges Sierra Leone to become current in its financial obligations to the Fund promptly and to avoid thereby the need for the Fund to take remedial action.

3. Consideration of the complaint in accordance with Rule S-1 and the Trust Fund notice particularly affects Sierra Leone. The member shall be informed by rapid means of communication of this matter and of its right to present its views through an appropriately authorized representative.

Decision No. 8638-(87/101) S/TR, adopted
July 8, 1987

8. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and Advisors to Executive Directors as set forth in EBAP/87/152 (7/7/87) and EBAP/87/153 (7/8/87) is approved.

9. TRAVEL BY MANAGING DIRECTOR

Travel by the Managing Director as set forth in EBAP/87/154 (7/9/87) is approved.

APPROVED: January 4, 1988

LEO VAN HOUTVEN
Secretary

b. Medium of Payment of Special Charges on Overdue Repayments and Interest on Trust Fund Loans

Decision No. 8165-(85/189) G/TR, adopted December 30, 1985, effective February 1, 1986, Section V, paragraph 2, shall be amended by the addition of the following sentence:

> Such payments may be made also in SDRs to a prescribed holder on behalf of the Special Disbursement Account, provided that use of SDRs is in accordance with Decision No. 8642-(87/101) S/TR, adopted July 9, 1987. (EBS/87/149, 7/6/87)

Decision No. 8641-(87/101) G/S/TR, adopted July 9, 1987

c. Use of SDRs in Payment of Trust Fund Obligations

In accordance with Article XVII, Section 3, the Fund prescribes that:

1. A participant, by agreement with a prescribed holder and at the instruction of the Fund, may transfer SDRs to the prescribed holder in repayment of Trust Fund loans, in payment of interest on Trust Fund loans and in payment of special charges in respect of overdue repayments and interest of Trust Fund loans.

2. The Fund shall record operations pursuant to this prescription in accordance with Rule P-9. (EBS/87/149, 7/6/87)

Decision No. 8642-(87/101) S/TR, adopted July 9, 1987