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Minutes of Executive Board Meeting 88/99

10:00 a.m., June 24, 1988

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
	E. T. El Kogali
	C. Enoch
Dai Q.	
	D. C. Templeman, Temporary
	E. L. Walker, Temporary
	G. Seyler, Temporary
	R. Morales, Temporary
M. Finaish	A. M. Othman
G. Grosche	K.-H. Kleine, Temporary
	J. Reddy
	L. M. Piantini, Temporary
	C. L. Haynes, Temporary
	A. R. Ismael, Temporary
	I. A. Al-Assaf, Temporary
	V. J. Fernández, Temporary
	M. Fogelholm, Temporary
	D. Marcel
	V. Rousset, Temporary
	G. P. J. Hogeweg
	I. Sliper, Temporary
	S. Rouai, Temporary
	V. K. Malhotra, Temporary
K. Yamazaki	S. Yoshikuni
	T. Morita, Temporary
S. Zecchini	

L. Van Houtven, Secretary and Counsellor
M. J. Miller, Assistant

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Also Present

IBRD: B. Tuncer, Africa Regional Office. African Department: G. E. Gondwe, Deputy Director; J. Artus, N. Abu-zobaa, D. T. S. Ballali, B. R. H. S. Rajcoomar, D. J. Scheuer. European Department: M. Russo, Director; P. B. de Fontenay, Deputy Director; M. Guitian, Deputy Director; D. J. Archer, M. T. Hadjimichael, L. Hansen, J. Saito, H. O. Schmitt, B. J. Smith, J. R. Wein. Exchange and Trade Relations Department: J. T. Boorman, Deputy Director; A. Basu, M. V. Carkovic, B. Christensen. Fiscal Affairs Department: A. A. Tait, Deputy Director. IMF Institute: A. M. Bile, Participant. Legal Department: H. Elizalde, A. O. Liuksila, J. V. Surr. Research Department: W. M. Corden. Treasurer's Department: D. Berthet. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: M. B. Chatah, A. G. A. Faria, P. Kapetanović, M. Pétursson, A. Vasudevan. Assistants to Executive Directors: F. E. R. Alfiler, S. Appetiti, D. Barr, H. S. Binay, R. Comotto, F. El Fiky, J. M. Jones, C. Y. Legg, D. V. Nhien, S. Rebecchini, G. Schurr, R. Wenzel.

1. NEW ZEALAND - 1988 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1988 Article IV consultation with New Zealand (SM/88/115, 5/26/88). They also had before them a background paper on recent economic developments in New Zealand (SM/88/128, 6/10/88, and Cor. 1, 6/22/88).

The staff representative from the European Department stated that the staff was proposing to put New Zealand on the bicyclic consultation schedule.

Mr. Sliper noted that he found such a consultation schedule for New Zealand acceptable. He then made the following statement:

> My New Zealand authorities concur generally with the staff analysis and the policy prescriptions presented in the staff report, which they view as fair and well balanced.
>
> In the decade 1974-84, New Zealand's economic performance was poor when measured against that of other industrial countries, which can be demonstrated as follows.

	1974-84	
	New Zealand	Total OECD
GDP per capita (Average annual percentage change)	0.3	2.0
Current account balance/GDP (Average percent)	-4.8	-0.3
Inflation rate (Average annual percentage change in GDP)	13.4	8.8

> At the same time, New Zealand progressively introduced a range of controls and protective instruments, with the consequence that resource allocation became highly distorted, and many activities expanded with subsidies and internal and external protective devices, including import quotas. Those controls reached their peak in 1983 and 1984, when layers of wage, price, and interest rate regulations were introduced to cope in part with large fiscal and external deficits.
>
> The task of restructuring was not only to dismantle the array of detailed administrative controls that had been created, but to rejuvenate the economy and move it from the slow growth path it had followed since the early 1960s. In short, the

economy had to be recreated, to ensure that it was more responsive to external events and able to generate sustained growth without high inflation and recurrent external imbalances.

Since mid-1984, New Zealand has been engaged in a very extensive restructuring process, in terms of both breadth and speed. The nature of those reforms is well documented in the staff report. The process of reform has not been without hitches and costs: there has been criticism about sequencing of the measures; monetary policy was too loose for a period in 1986, which set back the task of moderating inflation; the wage round in 1985 generated high real rates.

At the moment, New Zealand is in the middle of a recession. For calendar year 1988, real GDP growth is expected to be zero or slightly negative. Unemployment is high, at 7 1/2 percent of the labor force, and is projected to increase somewhat in the coming year. Inflation remains high, with the latest quarterly increase in consumer prices being just over 9 percent on an annual basis, although the trend is downward. Most commentators are suggesting an annual rate at year end (i.e., the quarter ending December 1988 over the quarter ended December 1987) of 5-7 percent.

To some extent the current recession can be seen as a delayed response to the contractionary policies which were introduced in 1984 and 1985. The impact of those policies was masked by a growth surge accompanying the liberalization of financial regulation policies. The slowdown in activity thus took longer to take effect than originally expected.

Much of the present economic policy debate in New Zealand centers on the appropriate mix of monetary, fiscal, and exchange rate management. Most of the commentators, including the Fund staff, are agreed, first, that monetary policy must remain tight, and second, that fiscal policy should absorb more of the adjustment burden. The evidence suggests that monetary policy was sufficiently tight in 1987, and has remained so for 1988. For much of that period, there has been a negative yield curve, with current interest rates on 90-day bills being about 16 percent and rates on five-year government stock being about 12-13 percent. Those rates have shown a decrease of about 4 percent over the last year, in line with the decline in the rate of inflation.

For 1987/88 (ending March 31), the Government recorded a small surplus in cash terms or a deficit of 2.2 percent of GDP, excluding asset sales. That represents a steady improvement over the last five years, when the fiscal deficit in cash terms reached a peak of 9 percent of GDP in 1982/83. However, nearly all of that improvement has come about on the revenue side, and it is generally accepted that more needs to be done in controlling expenditure, especially in the welfare area. In the last year, several reports have been published from various Commissions and Committees of Inquiry in the fields of education, health, and social welfare. Those reports are still being publicly debated, but it is becoming increasingly accepted that cost savings can be effected in those areas through better targeting, wider application of user fees, and more decentralization of decision making.

Over the last three years, New Zealand has continued to adopt a noninterventionist stance in respect of exchange rate management. That is in part a reflection of the high budgetary costs of past arrangements for maintaining a fixed exchange rate. My authorities agree with the staff's appraisal that further progress is required in disinflation. However, there appears to be an inconsistency between the call for continued disinflation and an implicit anxiety at the current level of the real exchange rate. While they would concede that firmer monetary conditions have contributed to an appreciation of the real exchange rate, they would note that that appreciation has been one of the principal transmission mechanisms of disinflationary monetary policy. They also believe that the appreciation of the real exchange rate has been due to an improvement of the terms of trade since the middle of 1986. In addition, as the staff report notes, the change in policy approach and associated reforms have improved expectations of the medium-term performance of the economy which is incorporated in the level of the real exchange rate. Ultimately, they see the aim of monetary policy as the achievement and maintenance price stability. They do not see competitiveness as being a direct objective of macroeconomic policy nor do they believe that monetary policy is generally able to determine competitiveness other than in the short term.

Since the staff mission, little new data have been released to change the economic outlook as presented by the staff. Monthly retail sales have continued to slow in real terms, indicating a substantial fall in domestic consumption. Public investment has continued to decline, although there has been a welcome pickup in private equipment sales. The New Zealand dollar has continued to strengthen against the U.S. dollar (to a current level of 69-70 U.S. cents), whereas the relationship to other currencies has been mixed, including a decline against the Australian dollar. The latest balance of payments figures confirm a current account deficit of slightly under 3 1/2 percent of GDP.

The next budget is due to be presented in the middle of July. The Minister of Finance has indicated that it will be difficult to bring the deficit down substantially because of the flat economy, and hence the flat or negative tax revenue. The fiscal strategy does however envisage a continuation of privatization and asset sales, and several public enterprises are at an advanced stage of planning for the introduction of private shareholding, or for complete sale to the private sector.

The wage round is just beginning, with the Government intent on continuing its approach of not becoming directly involved in the negotiation process. Intervention is viewed as damaging the Government's credibility and its policy approach of encouraging pricing decisions to be made at the microeconomic level, on efficiency grounds. The authorities hope that the round will produce further dispersion of wage increases, reflecting the different profitability positions of industries, and different supply and demand positions in the regions.

New Zealand is experiencing considerable economic pain at present, and the immediate outlook is for little improvement. Not surprisingly, such a situation has generated some criticism, both internally and externally, of New Zealand's economic adjustment effort.

In reaching a judgment about the adjustment strategy, it is important to keep in mind the extent of the protective and regulatory controls that existed in New Zealand at the beginning of the adjustment process. Most public and private enterprises were built up with large implicit and explicit subsidies, and key prices, particularly interest and exchange rates, were not encouraged to quickly filter through into the economy. The task of transforming those enterprises into efficient and internationally competitive operations is a huge endeavor. Also, overseas experience indicates that real adjustment to a low inflation growth path takes time, especially where the fiscal and external imbalances are large, and inflation is deeply embedded.

My authorities recognize that more needs to be done, particularly in controlling Government expenditure, and introducing more flexibility into the labor market. Moderating inflation remains the absolute priority, and success is being achieved in that area. The staff analysis presents two scenarios, with the second based on a lower wage growth and a more balanced fiscal position. The report qualifies the implications that can be drawn from those scenarios. My authorities are rather skeptical about the figures included in that analysis and the linkages that are implied. Specifically, they are not convinced that an exchange rate depreciation of the magnitude outlined would result from fiscal consolidation. Moreover, they question the ability of some unspecified form of incomes policy to prevent a large proportion of an exchange rate depreciation from feeding into wage settlements and into prices.

New Zealand's adjustment effort is continuing. My authorities are confident that they have laid the basis for a more responsive economy and that "the objective of a stronger, more efficient, and better balanced economy can certainly be achieved."

Mr. Seyler made the following statement:

It is especially worrisome to note that while most of the industrial world is experiencing a period of sustained growth, New Zealand is sliding into a recession. The explanation given by Mr. Sliper, which describes the current situation as a delayed response to the contractionary policies introduced in 1984 and 1985, is not wholly satisfactory.

We are more inclined to suppose that New Zealand is now paying the price for pursuing inappropriate fiscal and monetary policies over the last few years. First, the continuing rapid accumulation of public debt has led to a skyrocketing interest burden on the public finances, as shown in Chart 6 of the background paper on recent economic developments. In addition, the fact that about 50 percent of that debt is external renders New Zealand vulnerable to changes in foreign monetary and exchange policies.

Second, in a liberalized financial system like New Zealand's, capital flows respond sharply to variations in yields. For that reason, the adoption of a monetary policy which relies heavily on interest rates has a strong impact on exchange rates. That is at the root of the dilemma facing the authorities, who are stuck with the necessity of maintaining an interest rate which is consistent with a certain credit growth ceiling, but inconsistent with a competitive exchange rate level.

I would urge the New Zealand authorities to consider the example of the countries of the European Monetary System (EMS), which have long recognized the importance of orienting their monetary policies toward foreign exchange rate objectives. That policy stance is based on the experience of many countries, including New Zealand, which shows that credit demand is relatively inelastic with respect to interest rates, which means that monetary policy implemented through the interest rate channel requires relatively large interest rate movements to obtain the desired effects on credit demand. In New Zealand, the high real interest rates resulting from that monetary policy stance have slowed economic activity and added to the already high unemployment levels. An additional negative side effect has been a considerable increase in the public interest rate burden. Furthermore, the overvalued exchange rate of the New Zealand dollar resulting from the present stance of monetary policy, combined with the existing positive inflation differential vis-à-vis competitors, has seriously eroded New Zealand's external competitiveness, and lies at the root of the stubbornly persistent current account deficit. It would be rather naive to suppose that a huge appreciation like that affecting the New Zealand dollar could be corrected through a restructuring of the economy.

In retrospect, it is clear that the New Zealand authorities should have resisted the temptation to let the exchange rate for the New Zealand dollar appreciate. Such an appreciation could have been prevented through central bank intervention, since it is easier to prevent exchange rate appreciation than depreciation. The proceeds of the intervention could then have been applied to repayment of part of New Zealand's high external debt. Any inflationary pressures resulting from the credit growth accompanying that intervention could have been neutralized by the reintroduction of some limited financial regulations such as compulsory noninterest-bearing deposits at the central bank.

My present policy advice is based on the assumption that a small open economy like New Zealand's finds it difficult to liberalize its financial system completely without harmonizing its monetary policy with the monetary policies of the large industrial countries. New Zealand has entered a vicious circle, in which decreasing economic activity results in lower than expected tax receipts and a persistent government deficit, a deficit which will force the authorities to adopt additional measures which will slow the economy still further. The only way to break that circle is to adopt policies like those underlying the staff's Scenario B, although a substantial one-time devaluation, with accompanying measures, might be preferable to the gradual depreciation recommended by the staff. That kind of shock therapy was successfully used by Belgium in 1982. It has the advantage of surprise, preventing the economic agents from undermining the Government's corrective measures by taking countermeasures in advance.

Mr. Enoch observed that the staff report and background paper reviewed clearly the range of measures that had been introduced in New Zealand over the previous four years to tackle the major internal and external imbalances facing the economy. It was already clear from a number of economic indicators, such as the transformation of a large fiscal deficit in 1983/84 into a small surplus in 1987/88, and the revival of private investment in 1987, that a great deal of progress had been made. However, most of the benefits had yet to be realized. The staff papers demonstrated that New Zealand's economy was entering a new phase in an adjustment process that was presenting the authorities with particularly difficult challenges. As other countries had found, inflation and inflationary expectations were often deep-seated, so that robust corrective measures had sometimes to be implemented over an extended period in order to eliminate inflation and enhance prospects for the resumption of growth.

The New Zealand economy was currently in a recession, Mr. Enoch noted, so that persisting with adjustment was particularly difficult, and the authorities should be commended for their full commitment to the present strategy. As the United Kingdom's experience had shown, adjustment from deep-seated structural inefficiencies and prolonged economic slowdown took time, but such adjustment ultimately brought important medium- and long-term benefits. He endorsed the staff appraisal, and urged the authorities to continue their economic restructuring.

Given the projected real decline in economic activity over the following year, focusing fiscal policy on expenditure restraint seemed appropriate, Mr. Enoch remarked. A reduction of the public sector's demand for domestic savings was important, so that private sector investment and growth could be stimulated. He welcomed the continuation of the privatization plans and the commercialization of government departments, which would ease the fiscal position. He concurred with the staff that pressures for further spending on social services should be resisted by better targeting and improved efficiency, and hoped to see the early implementation of the recommendations of the Commissions and Committees which had recently conducted studies in that area. On the revenue side, he was pleased to see that tax reform was still high on the agenda; he would be interested to know whether the introduction of a capital gains tax was planned.

The policy dilemma between maintaining a tight monetary policy and safeguarding international competitiveness was familiar, Mr. Enoch commented, both from the experience of the United Kingdom and from that of Australia, as had been shown in the Board's discussion of Australia recently (EBM/88/92, 6/15/88). He agreed with the staff and with Mr. Sliper that the authorities should continue with a strong monetary policy in order to reduce inflation and inflationary expectations. He recognized that the exchange rate was a principal transmission mechanism of inflation. While he welcomed the downward pressure put on inflation by the exchange rate appreciation, it was not inconsistent to express concern as well, in light of the effect of currency appreciation on New Zealand's competitiveness.

The staff had presented alternative medium-term scenarios depending on different policy mixes, of which an important component was a different exchange rate strategy, Mr. Enoch went on. While he found those scenarios interesting, he agreed with Mr. Sliper that it was difficult to draw particular policy recommendations from them, in part because it was not possible to disentangle the effects of the various alternative policy options in them. The empirical results reported in Appendix III of the background paper, although interesting, were not strong evidence in favor of using the exchange rate to improve competitiveness, at least not on its own. There was a serious policy dilemma, but attempts to ameliorate it by working on the other instruments available to the authorities were needed. Thus, further progress on fiscal retrenchment, which would be prudent in any case so that New Zealand's debt burden could be reduced, would serve to bring down the level of interest rates. Further supply-side measures should be adopted to improve industrial efficiency as well.

Significant structural reforms had already been made, Mr. Enoch noted, and he applauded the efficiency gains that had already been achieved, particularly in agriculture and in state-owned enterprises. However, he concurred with the staff that there was much greater scope for flexibility, especially in the labor market. The Labor Relations Act and the measures introduced in December 1987 constituted only a very limited reform, and much could yet be done to decentralize wage increases. Moreover, more could be done to increase domestic efficiency by reducing import barriers. A substantial reduction in tariff barriers had already taken place, but there was considerable scope for speeding up the program that had been announced for the next few years, especially since the liberalization seemed to have occurred without excessive disruptive effects so far on the domestic economy.

The perspective he had taken was rather different from that of Mr. Seyler, Mr. Enoch commented, which he had found very thought provoking. But three points needed to be made in regard to the shock therapy applied in Belgium in 1982. First, the institutional background in Belgium was rather different from that in New Zealand. Belgium was able to devalue through setting new parities within the European Monetary System; as New Zealand had a freely floating currency, the concept of a one-off devaluation was not entirely clear, unless the floating exchange rate system itself was to be reviewed. Second, Belgium's policy over the past few years was not perhaps very different from that of New Zealand, he believed. The staff report for the 1988 Article IV consultation with Belgium (SM/88/75, 3/31/88) had commended Belgium's adoption of a strong currency approach within the European Monetary System, and had linked that to the increased credibility of Belgium's overall policy stance. Third, there were some lessons to be learned from the Belgian experience, particularly in the labor market. The Belgian authorities had withdrawn from an indexed, centralized wage setting process, and no significant upsurge in inflation had resulted. Labor market reform was an urgent task in New Zealand, and the Belgian experience in that regard appeared to him to provide some encouragement.

He had been intrigued to read in the staff papers that the stock market reversal of October 1987 had had a significant impact on the economic outlook for New Zealand, Mr. Enoch remarked, in terms of dampening both growth and inflationary expectations. That seemed to differ from the experience of many other countries, where expectations of a significant reaction to the stock market decline had not in fact been met. He would be interested in the staff's comments as to why New Zealand's experience had been different, especially as he would have thought that a case could be made that the present downswing in New Zealand was already in the cards before the stock market crash.

If the New Zealand authorities were content with the staff's proposal to move New Zealand onto the bicyclic consultation schedule, he could support it as well, Mr. Enoch stated. He wished to express his support for the authorities' courageous economic strategy. Over the medium term, such a strategy should lead to a significant strengthening in economic performance, provided that the authorities continued along the present path.

The Chairman said that he had found Mr. Enoch's remarks about the necessity of departing from gradualism from time to time particularly relevant.

Mr. Templeman made the following statement:

> At the last Article IV consultation on New Zealand, this chair, and the Board generally, commended the authorities for important progress that had been made in the area of structural reforms, but expressed some concern about the extent of progress in achieving macroeconomic goals. In the view of my authorities, that overall evaluation continues to be justified. During the past year, further advances have been made on tax reforms and reorganization of the public sector, and, to a lesser extent, on labor relations and import liberalization. Macroeconomic performance was mixed. It is true that inflation, and, what is perhaps more important, inflationary expectations, have come down, that wage rate increases were more moderate, that there was some recovery of fixed investment, and that the budget deficit declined. However, GDP was stagnant, unemployment rose, the real effective exchange rate continued its steady appreciation, and the current account deficit was virtually unchanged, despite the recession and the substantial improvement in the terms of trade. Furthermore, for 1988/89, growth is likely to be negative, unemployment will probably continue to rise, the current account deficit ratio is not likely to fall much, inflation may come down further but will remain high by international standards, the fiscal deficit is not likely to fall much, and the real effective exchange rate could continue to rise.
>
> The assignment of top priority to a further reduction in inflation seems quite appropriate. Achievement of a 7 percent inflation rate this fiscal year, or more optimistically, the 5-7 percent rate mentioned by Mr. Sliper, would represent substantial progress. But that rate would still exceed the average for other industrial countries by several percentage

points. Given the authorities' determination not to employ exchange rate depreciation as a way of strengthening New Zealand's international competitive position, a very large burden falls on the containment of domestic costs and prices. The staff report and Mr. Sliper's statement express optimism about the outcome of the new round of wage negotiations. My authorities hope that that view will prove to be justified.

The continuation of labor shedding and the rise in unemployment in recent years, plus the deceleration of price inflation, should help to assure that outcome. However, this chair shares the continued concern expressed by the staff and by the authorities about the need for greater flexibility in labor markets, and urges the authorities to examine labor market reforms which could have a more direct effect on labor mobility and wage differentiation than last year's Labor Relations Act.

I have already alluded to the view expressed by the staff and the authorities in favor of strengthening and preserving New Zealand's international competitive position by cost control, rather than by exchange rate depreciation. This chair expressed some sympathy with that view last year, and continues to recognize the validity of the argument. Still, the steady real effective appreciation of the New Zealand dollar, by a cumulative total of about 40 percent since July 1984, cannot help but raise serious questions about New Zealand's competitive position, and about the adequacy of the pace at which domestic costs are declining. Other warning signs are recent adverse shifts in the volume of exports and imports, the apparent stabilization of current account deficits around 3 1/2 percent of GDP, and the high foreign debt and debt service ratios of 55 percent and 38 percent, respectively.

Further progress on import liberalization could be helpful in exercising stronger external discipline over domestic cost and price movements. My authorities welcome the latest measures to eliminate most quantitative restrictions, except for items covered by industry plans, the fact that those plans are subject to periodic review, that terminal dates have been set for elimination of special protection in some cases, and the authorities' intention to cut tariff duties by half over the next four years. In that respect, it would be interesting to hear a fuller evaluation by the staff of the current level of protection, and the economic significance and adequacy of the timing of the planned cuts in import duties.

The urgency of accelerating progress in strengthening New Zealand's balance of payments position can be seen in the staff's two medium-term balance of payments scenarios, both of which continue to show debt ratios in the 50-63 percent range, and debt service ratios in the 36-39 percent range, as late as

1992/93. Even if Mr. Sliper's cautionary note about the reliability of such projections is accepted, the data offer some useful evidence of the potential size and duration of the external imbalance problem, and of the utility of a broad policy mix for dealing with it.

Clearly, much of the burden of further adjustment must fall on a reduction in the fiscal imbalance. If prospects for reducing the current account deficits and the corresponding reliance on foreign savings are as limited as suggested, then significant fiscal surpluses may be required. At the same time, a further strengthening in the fiscal balance should also contribute to the containment of domestic costs and prices by helping to reduce and reallocate domestic absorption, bring down interest rates, and moderate inflationary expectations. This chair shares the view that it would be appropriate for emphasis to be placed on expenditure reductions in the future, including especially on social expenditures, which are now the subject of review, and taking into account the much larger share of past fiscal adjustment borne by the revenue side of the accounts. In that connection, it would have been interesting to see medium-term fiscal projections to correspond to the balance of payments projections.

I commend the authorities for the continued progress they are making on tax reform and on reorganization of the public sector, including the public enterprises. Reductions in marginal personal income tax rates, the specification of fewer tax brackets, the elimination of most personal exemptions, and the cut in the corporate tax rate should have favorable, long-term effects on incentives. Similarly, the sale of assets, including shares in the public enterprises, has a legitimate role to play, both in terms of the budget deficit problem and in achieving a slimmer and more efficient public enterprise sector.

The authorities have continued to make quite impressive progress in structural reforms, and fairly good progress in the macroeconomic area. However, one gets the impression that there is insufficient momentum in the latter case, with stronger fiscal, and perhaps exchange rate, adjustment needed.

My authorities are inclined to question whether a shift to a 24-month cycle, as proposed by the staff, would really be appropriate for New Zealand, given New Zealand's economic outlook. This chair would welcome the views of staff and of other Executive Directors on the matter.

Mr. Dai made the following statement:

The wide-ranging program of economic restructuring undertaken by the New Zealand authorities in the past few years has been very impressive. It appears that the extent and depth of this transformation has required not only courageous endeavors, but also time and patience. I endorse the staff appraisal in general.

It seems that New Zealand's economy is still troubled by problems of stagflation, and is therefore inevitably facing a dilemma: to alleviate stagnation or recession might aggravate the already high rate of inflation, whereas attempts to suppress inflationary pressures by intensifying the tight monetary policy could push the interest rate even higher, thus leading to further appreciation of the New Zealand dollar, weakening external competitiveness, restraining domestic investment, and consequently having a deleterious effect upon economic activity. While I understand the reasoning behind placing the policy of containing inflation as a top priority, I wonder what other supply-side policy could be considered in support of the restructuring program, with a view to reviving economic growth and easing inflation in the near future.

The prolonged weakness of New Zealand's economy, evident in chronic inflation, persistent current account deficits, and the accumulation of a large external debt, points to the theoretical result of a weakening New Zealand dollar. Even with those adverse elements, however, the New Zealand dollar has appreciated against a background of persistent internal and external imbalances. I would like to know what are the economic fundamentals underlying the appreciation, besides the factors of higher interest rates and the public's confidence in the authorities' policy stance, as the staff report stressed. If New Zealand's economy is still heavily dependent upon temperate climate agricultural products in which it enjoys a strong comparative advantage, I would like to know the price elasticity of those products in New Zealand's export markets. Also, if an appreciation of the New Zealand dollar is inevitable as a result of a tightening of monetary policy, how serious will the negative effects of such an appreciation be on New Zealand's external competitiveness and external account balance?

Mr. Al-Assaf made the following statement:

The New Zealand authorities are continuing their major reform effort that is transforming the economy from one of the most regulated among the industrial countries to one with far greater market orientation. They have adopted a medium-term perspective, whereby they are concentrating on microeconomic reforms in the hope that macroeconomic equilibrium will gradually take place.

The authorities deserve to be strongly commended for that reform effort, and for their willingness to accept short-term costs in order to achieve medium-term goals. At this stage, they need to achieve two basic objectives--a reduction in inflation and an improvement in the external account. As in some other cases, the authorities face the dilemma that, in order to realize the first objective, they may have to sacrifice the second.

I believe that in the case of New Zealand that dilemma is less pressing, since inflation represents an immediate concern, while the reduction in the current account deficit is more a medium-term concern. That is highlighted by the fact that New Zealand's current account deficit is the result of a large deficit on the services account stemming from an outflow of net investment payments, rather than from a trade deficit. I can therefore strongly endorse the authorities' decision to give inflation the higher priority.

In light of the long-standing persistence of inflation and the importance of expectations in any disinflationary policy, like Mr. Enoch, I see merit in the authorities' decision to further tighten the monetary stance. To lend further support to that anti-inflationary policy, fiscal contraction is also called for. I am encouraged by the authorities' recognition that there is scope for further expenditure tightening, and I urge them to undertake the needed measures. While tighter monetary policy would lead to higher interest and exchange rates, fiscal contraction, by reducing the public borrowing requirement and thus allowing an eventual reduction in the rate of interest, should have a balancing effect. However, I note Mr. Sliper's point that the opposite could occur, as an improvement in the public finances could create greater confidence in the economy, thereby causing the demand for money, and thus interest rates, to increase.

It can be argued that macroeconomic policies may not be the most appropriate tools for achieving competitiveness. In the case of New Zealand, even if the exchange rate depreciates, it may not secure the desired improvement in the current account, since many of New Zealand's exports may not respond significantly to exchange rate changes, as Mr. Dai has observed.

It is therefore evident that a more broad-based and medium-term policy mix is needed to address the current account deficit. The restructuring process itself can offset a loss in competitiveness, mainly through import liberalization, labor market reforms, and improvements in production efficiency. In that context, I welcome the additional import liberalization steps anticipated for July 1988, but further efforts at labor market reform and wage flexibility may also be needed. A country like New Zealand, which relies heavily on capital imports, can only gradually improve its current account as it slowly reduces its reliance on foreign savings. A further look at the tax system, with a view to providing appropriate tax incentives for enhancing domestic savings, may be desirable.

I agree with the authorities that inflation should be awarded the top priority, and that a medium-term approach should be adopted for addressing the current account difficulties. The authorities are following the right course of action despite the short-run costs they may have to endure. Such an approach will gradually improve New Zealand's export performance and reduce dependence on foreign capital.

I support the proposal to put New Zealand on a bicyclic consultation schedule.

Mr. Grosche made the following statement:

The New Zealand authorities deserve to be commended for their continued commitment to a basic reorientation of the economy. They are pursuing their efforts despite the fact that bold and comprehensive adjustment measures taken since 1984 have not yet generated improvements in major economic indicators. Unemployment has risen once again in 1987, and, according to the staff's forecast, will remain at high levels for the coming years. Output growth in 1988 will be negative, and the external position is still not sufficiently balanced. On the positive side, however, the marked reduction in inflation and the considerable progress made in correcting fiscal imbalances should be noted. The absence of significant overall improvements should not come as a surprise, given the large and deep-seated macroeconomic and structural imbalances prevailing at the outset of the reform process.

As Mr. Sliper has stated, the authorities are preparing further measures, in particular in the fiscal and structural areas, which is good news. I am not sure, however, whether the macroeconomic policy mix will be optimal. I am particularly concerned about the level of interest rates, which are still very high despite their recent decline, and their impact on growth, employment, and the external position. Since I can support the staff's analysis and recommendations, I will concentrate my remarks on that aspect.

I agree that monetary policy should continue to be tight, aiming at a further reduction of inflation. Nevertheless, greater scope for reducing interest rates could be gained by further strengthening fiscal policies, particularly by accelerating the restructuring of the budget. The improvement in the fiscal position until now stems mainly from increased revenues, while expenditures continued to increase. Asset sales of public enterprises are certainly welcome, not only for budgetary reasons, but it needs to be borne in mind that such measures cannot be repeated. Delaying expenditure cuts will make the restructuring process a prolonged and therefore increasingly painful one. I recognize, of course, that the cutting of expenditure is difficult in a situation of high unemployment and negative output growth. The authorities therefore deserve to be commended for their intention to comb through social expenditures and make cuts only where they are not likely to reduce the quality or scope of public services.

While a more ambitious fiscal policy could create more room for lowering interest rates and thereby the exchange rate, domestic price-cost pressures need to be contained at the same time, in order to provide a floor for the necessary downward correction of the exchange rate.

On wages in particular, I agree with the authorities that there should be no direct interference with the negotiating process. However, the authorities should remind the negotiating parties of their responsibility, as excessive wage increases will have negative repercussions on employment. I am aware of the delicacy of such an approach; but as the staff rightly notes, a strengthening of domestic policies would clearly be preferable to depreciations when it comes to maintaining external competitiveness. I agree with the staff's conclusion that under present circumstances there is no scope for monetary or intervention policies to encourage a weaker dollar.

I would like once again to commend the authorities for their dedication to adjustment. In continuing on their current path with determination, they should be able ultimately to enjoy the successes they highly deserve, and I am confident that in two years' time it will be possible to discuss a paper which paints a brighter picture of New Zealand's economic situation.

Mr. Reddy made the following statement:

I broadly agree with the staff's analysis and appraisal. The authorities deserve to be congratulated for the bold and far-reaching measures they have taken to deal with a number of structural impediments to the efficient running of the economy. Price liberalization, deregulation, privatization, tax reforms, trade policy reforms, and other measures to increase competition in the economy are welcome developments, even though the full beneficial effects of some of them will only be realized over time.

The stance of macroeconomic policies is broadly appropriate. While I appreciate that the structural measures which have been introduced will lead to better price performance in the longer term, I would have liked to see wage policy and fiscal policy make a greater contribution to the adjustment process, so that reliance on monetary policy as an instrument of adjustment could be reduced somewhat, in order to avoid undue appreciation of the exchange rate. However, reflecting upon Mr. Sliper's statement, it now appears that the expectation of a further reduction in the budget deficit may not be realistic, because the current economic recession is not only likely to reduce revenues, but also to lead to increased expenditures for unemployment benefits. The authorities will thus have no choice but to continue to rely heavily on monetary policy as an instrument of adjustment. If that scenario were to be played out, a significant increase in interest rates and a further appreciation of the exchange rate could occur. Such developments could be damaging to New Zealand's economy.

The unemployment rate has now reached 7.5 percent of the labor force, and is projected to rise further in the coming year. The long-term solution to that problem would be to improve cost competitiveness through lower wages and a lower inflation rate, rather than through a countercyclical macroeconomic policy. Greater reliance may have to be placed on structural policies in dealing with the unemployment problem, since the scope for countercyclical policy remains extremely limited. If the current recession proves to be severe and prolonged, the authorities may have no option but to accept a somewhat higher fiscal deficit until economic conditions improve.

The staff reports used to make clear judgments on the appropriateness of exchange rates for member countries in the past. These days, staff reports are hesitant to make pronouncements on exchange rates because it is assumed that the effects of market forces on the outcome for exchange rates is the right one, even though experience with the value of the U.S. dollar in the early 1980s demonstrates that that is not always the case. In the case of New Zealand, we are informed that the current account deficit is not sustainable, that the country has a very large external debt, that the inflation rate is much higher than that of its trading partners, and that both the nominal and the effective exchange rates for the New Zealand dollar have appreciated substantially. One additional indicator which might have helped the Board to reach a judgment on the appropriateness of the exchange rate might have been the profitability of the export sector. The fact that New Zealand relies heavily on agricultural exports, combined with the fact that farm incomes have declined by over 50 percent in the four-year period to 1986/87, suggest that the profitability of the agricultural sector has eroded considerably. Perhaps Mr. Sliper or the staff could provide some information on the profitability of the export sector, which holds the key to the future viability of New Zealand's balance of payments.

My views on the exchange rate of the New Zealand dollar are very similar to those of Mr. Seyler. Like him, I also believe that the New Zealand dollar is overvalued, and that it may be wishful thinking to assume that the restructuring of the economy, together with somewhat tighter macroeconomic policies, will correct the huge appreciation of the New Zealand dollar that has occurred over the last few years.

I also concur with Mr. Seyler's view that some form of exchange market intervention may be beneficial in correcting the exchange rate overvaluation. The staff does not seem to favor that approach, since it would like to see the depreciation take place through lower real wages and lower inflation. Indeed, that would be the ideal solution. At the same time, an examination of recent events reveals that inflation has remained higher in New Zealand than in its trading partners, resulting in a sharp appreciation of the real effective exchange rate of the New Zealand dollar. That suggests that the exchange rate must now be depreciated, especially when the current account position and the external debt position of the country are taken into account.

With regard to trade policies, I note that some of the import barriers have been lowered, and that there are plans for a gradual reduction in tariffs over the next four years. I would like to know, either from the staff or from Mr. Sliper, how the pace of import liberalization will be affected by the recent free trade agreement between Australia and New Zealand.

Mr. Hogeweg commented that the description in the staff report of New Zealand's comprehensive package of structural reform and coincident restoration of macroeconomic balance, in its fourth year of vigorous implementation, made fascinating reading. The transition had evidently been far from painless. In his view, the authorities should be commended for their perseverance and evident strong conviction that their policies would pay off in the end.

He understood that the authorities were planning asset sales in order to reduce the level of outstanding public debt, Mr. Hogeweg went on. For such an approach to have a favorable budgetary effect, revenues from the assets must be far smaller than the interest rate burden on the debt, as the staff had implied. The level of revenues that could be expected, however, should be reflected in the prices for which the assets could be sold. Was it correct that potentially large efficiency gains could be realized by those companies, and that those potential gains would be reflected in the sales price?

While asset sales would contribute to a further strengthening of the budget, they should be seen as separate from other measures needed to strengthen the budget that could increase domestic savings and relieve some pressure on monetary policy as well, Mr. Hogeweg observed. Like Mr. Enoch, he was struck by the fact that, with respect to monetary policy, the authorities had used the stock market crash to break inflationary expectations. That stance, which was very different from that taken elsewhere, evidently reflected different circumstances and a judgment as to whether recession or inflation was most feared.

The tight monetary policy stance had led to an appreciation of the New Zealand dollar, Mr. Hogeweg remarked, which had meant a loss of competitiveness and a weakening of the external accounts. In that connection, he did not agree with Mr. Seyler. In his view, there was certainly no scope for monetary policy to be geared toward a weaker New Zealand dollar, because serious damage to the Government's credibility in fighting inflation would be implied. Moreover, if fiscal and structural policies were successful, and if pressure on financial markets was thus relieved, whether the exchange rate would indeed fall in response to lower interest rates would remain to be seen, because confidence in the economy would have improved concurrently. He expected that a similar reason was behind the authorities' skepticism on the linkages implied in the staff's second medium-term scenario. Even then, of the two scenarios presented in the staff paper, that scenario was clearly preferable. It thus seemed advisable to try to adjust to the present exchange rate level as far as possible.

Structural policy was certainly an important part of such an adjustment, Mr. Hogeweg continued. In that connection, he noted that the staff had some reservations about the decision in New Zealand to leave wage bargaining to employers and unions--a decision which was remarkably opposite to that taken in Australia. The staff had seen the advantage in terms of labor market flexibility, but had feared the outcome in view of the potential impact on inflation. He hoped and expected that the tight monetary policy and weak competitive position of New Zealand would tend to keep the outcome of those wage negotiations within reasonable bounds.

The case of New Zealand was especially interesting, since the response of the economy was lagging behind the clear progress which had been made in structural reform, Mr. Hogeweg concluded. The staff saw as the main policy challenge in the period ahead the translation of that progress into improvement in macroeconomic performance. However, there was not much more the authorities could do to facilitate the adjustment process, and certainly not through a stimulatory fiscal or monetary policy. In his view, the challenge lay in not relaxing the policy effort, but rather in intensifying it, and in being able to wait for the economy's positive response, which was sure to come.

Mr. Yamazaki made the following statement:

The authorities have courageously continued to pursue, with great determination and in spite of difficulties, an economic stabilization program with a strong emphasis on market forces, in a clear departure from past policies of controls and intervention. Over the past few years, significant progress has been achieved in structural reform areas. In particular, the financial sector liberalization, the cut in export subsidies, and the tax reforms are commendable. Fiscal and monetary conditions were generally kept tight in order to reinforce the structural reform, and that policy stance continued in 1987/88, with the budget financial balance having declined to 2.2 percent of GDP. The general economic climate, however, was not necessarily favorable to the authorities. Real GDP growth fell to 0.1 percent, and negative growth is expected for the next year, while the rate of inflation remained at a persistently high level.

Now that weak business conditions are widespread, the appreciated exchange rate is not the only factor to be blamed. It now seems clear that the generally tight fiscal and monetary policies have also contributed to sluggish economic growth. Despite that difficult situation, the authorities are determined to continue to place a high priority on disinflation, while the weak economic climate will be ameliorated by enhanced economic efficiency through further structural reforms. This chair strongly supports the authorities' strategy, because the long-run benefits are obvious, despite the short-run costs which the authorities are now bearing. From that viewpoint, the authorities' patience and persistence are welcome and encouraging.

I generally endorse the staff's appraisal. With respect to fiscal policy, the scenario prepared by the staff in the paper shows the importance of fiscal consolidation. Persistent efforts to cut the budget deficit, if successful, would help reduce the burden on monetary policy, and thus contribute to the easier and earlier attainment of overall economic health. There is more scope for curtailing the budget deficit, especially in terms of the financial balance.

The focus of means to reduce the budget deficit should be on expenditure cuts, rather than on a tax increase. The staff has pointed out that large savings could be achieved in the health programs without substantially affecting the quality of service. Under those circumstances, and in the face of stagnant domestic demand, a further tax increase can and should be avoided.

With respect to monetary policy, the stubbornness of inflation is disappointing. There is thus a further need to consistently continue a tight monetary policy, despite the probable adverse effects on other areas, especially on the exchange rate. Indeed, the current high rate of inflation partly reflects the factor of inflationary inertia; a consistent tight policy would be required to remove it, and that is therefore highly advisable. I therefore welcome the authorities' determination in that area.

Comparatively slow progress has been made in the area of wage policy. Although we recognize and welcome the Government's important decision to disengage itself from the wage bargaining process between employers and unions, the new Labor Relations Act does not seem to have worked out very well; some framework for making the labor market flexible must be considered.

On the external sector, I welcome the authorities' plans for new steps to be taken in import liberalization, and hope that those measures will contribute to a more efficient allocation of domestic resources and a reduction of the inflation rate.

I support the placement of New Zealand on the bicyclic consultation procedure.

Mr. Fernández stated that some progress had been made to reduce macroeconomic imbalances in New Zealand's economy over the last year. However, despite trade liberalization, a strong improvement in the terms of trade, and a sizable appreciation of the real effective exchange rate, inflation vis-à-vis other OECD countries remained high. That unsatisfactory situation pointed to the need both to continue efforts to control production cost pressures, and to make the supply side of the economy more flexible.

Fiscal policy should continue to focus on reducing the fiscal deficit, Mr. Fernández continued. However, deficit reduction should be achieved in the future mainly through expenditure reductions. Deregulation of the financial economy and balance of payments liberalization should be continued, although his authorities understood the problems of sequencing and speed which the New Zealand authorities had experienced, as Mr. Sliper had noted. Most experts in the economics of liberalization would have advised the authorities to liberalize the current account first, and to liberalize, slowly but surely, the capital account only later, with a liberalization of short-term capital movements only at the end of that process. He had the impression that the implementation of internal financial market reform and capital movement liberalization had been too soon and too fast in New Zealand.

He would like to stress the need for further flexibility on the supply side of the economy, particularly in the labor market, Mr. Fernández observed. Keeping labor costs under control was essential for the reduction of inflation, and in order to provide monetary policy with the necessary margin of maneuver so that further increases in interest rates could be avoided. His chair strongly supported the staff's view in that regard, and deemed the outcome of the coming wage round to be critical.

The main problem of New Zealand's economy was the high rate of inflation, Mr. Fernández remarked, as a lower inflation rate was a necessary condition for sustaining New Zealand's external competitiveness. However, because of deregulation and innovation in financial markets and capital movement liberalization, the implementation of monetary policy had been difficult. With a flexible exchange rate regime and with the difficulties that the authorities had had in controlling a monetary aggregate, the identification of a monetary anchor for the economy was not easy. But nominal wage determination had been left to the social partners. Under those circumstances, he would appreciate it if the staff could comment on what would be the most desirable anchor for monetary policy.

Against that background, Mr. Fernández went on, his chair's preferred strategy to deal with the problem of inflation would be, first, a large reduction in the fiscal deficit; second, a large reduction in the cost of production of goods and services; and third, a neutral monetary policy stance. There was probably a consensus with respect to the first two strategies, so he would comment only on the third. By neutral monetary policy stance, he meant an expansion of the money supply that just satisfied the flow demand for money. Such a policy was not easy to implement, and a successful outcome depended on the common sense and skill of the monetary authorities. When the nominal exchange rate was appreciating and, simultaneously, nominal interest rates were high, the conclusion that could be drawn was that real interest rates were high. In that case, it was not clear that monetary policy should be used actively as an anti-inflationary instrument, as a too-restrictive monetary policy stance would cause interest rates to rise and would put further upward pressure on the exchange rate, with adverse consequences for the export sector. In that regard, the Government and many observers had pointed out that the exchange rate was clearly overvalued, although it was not easy to determine the equilibrium level for that rate, particularly in the middle of a liberalization process. His chair would agree that uncontrolled capital inflows were keeping the exchange rate overvalued in terms of purchasing power parity.

Most of the policy measures which the authorities had adopted over the last two years had been in the right direction, Mr. Fernández concluded. His chair encouraged the authorities to speed up import liberalization. If it was the wish of the New Zealand authorities, his chair could support the staff's recommendation that New Zealand be placed on the bicyclic consultation procedure.

Mr. Haynes stated that the New Zealand authorities had undertaken an ambitious adjustment effort and had had a number of impressive successes, as the staff report had made clear. He generally supported the staff appraisal.

Despite the authorities' successes in managing the economy, important challenges remained, Mr. Haynes commented. While there had been substantial progress in fiscal consolidation, there was no room for a relaxation of efforts. That observation was particularly compelling in the light of the large public debt and debt service burden, which limited room for fiscal maneuver. At the same time, there was a need to support the necessarily restrained orientation of monetary policy with a continuing ambitious fiscal effort. He had noted Mr. Sliper's observation that it would be difficult to reduce the deficit substantially under current circumstances. Nevertheless, he encouraged the authorities to strengthen the fiscal position over the next few years.

With respect to monetary policy, Mr. Haynes went on, the New Zealand authorities had experienced increasing difficulty in interpreting monetary and financial data, and of exploiting the most appropriate techniques and settings under which monetary policy would be most influential. Under those circumstances, the New Zealand authorities were pursuing an eclectic approach to monetary policy, in which the yield curve played an important part. He would encourage the authorities to persevere in their efforts to refine the instruments of monetary policy, and to move toward establishing a more clearly defined anchor. He wondered if the staff or Mr. Sliper could provide some insight on the establishment of a monetary policy framework which exploited the information provided by the yield curve.

Continued disinflation must remain a priority for the New Zealand authorities, and containment of inflation was essential for better medium-term prospects, Mr. Haynes noted. Monetary or intervention policies to encourage a weaker New Zealand dollar would undermine the credibility and efficiency of the disinflation effort, especially in the context of the current labor market situation, and consequently was an approach that should be avoided at present.

He commended the authorities for their ambitious program of microeconomic and structural reforms, Mr. Haynes concluded. There were, nevertheless, additional steps, particularly in the area of labor relations, that remained to be taken, but he welcomed the Government's intention not to become directly involved in the wage negotiation process. He congratulated the New Zealand authorities for their ambitious and in many respects successful efforts, and urged them to persevere with their adjustment path. He supported the staff's recommendation that New Zealand be placed on the bicyclic consultation procedure.

Mr. Morales stated that he was in general agreement with the staff report. New Zealand had implemented and sustained a strong adjustment program over the last four years, which had already proved effective in correcting internal and external imbalances. In previous discussions on the economy of New Zealand, his chair had welcomed the approach the New Zealand authorities had adopted to change the economy in the medium term, an approach which had relied strongly on market forces. The Government had been successful in implementing a set of structural policies, including deregulation of financial markets, the floating of the New Zealand dollar, the lifting of wage and price controls, the removal of export subsidies, and the introduction of tax reforms. At the same time, an impressive fiscal adjustment had been achieved: the budget deficit, at 9 percent of GDP in 1983/84, had been turned dramatically into a 0.8 percent surplus for 1987/88. Excluding proceeds from asset sales, the deficit had been reduced to 2 percent of GDP, implying a significant strengthening of public finances.

However, New Zealand was now faced with the difficult task of consolidating its anti-inflation policy and simultaneously laying the foundation for a resumption of investment and growth, Mr. Morales continued. The rate of unemployment was very high by historical standards, and the size of the current account deficit was incompatible with the achievement of a reasonable declining trend in the debt ratio. Therefore, the medium-term scenarios presented by the staff clearly suggested that a broad-based mix of policies was the preferable option for the future, rather than reliance on monetary policy, in order to achieve a better economic growth performance. He welcomed the resolution of the New Zealand authorities to continue with the adjustment process, and the decision to introduce more flexibility into the labor market and to control government expenditure.

He commended the authorities for their achievements in implementing structural changes and for their determination in pursuing a strong adjustment program, Mr. Morales concluded. He supported the proposal to place New Zealand on the bicyclic consultation procedure.

Mr. Zecchini made the following statement:

> The New Zealand authorities should be commended for embarking on a comprehensive structural adjustment strategy aimed at transforming one of the most regulated OECD economies into a more market-oriented and flexible one. Financial deregulation, trade liberalization, fiscal and public sector reforms, and innovative labor legislation have been the cornerstones of such a broad effort, for which some costs obviously cannot be avoided. Those costs have shown themselves in a sluggish pace of economic activity (GDP growth was 0.1 percent in 1987/88), rising unemployment, and substantial inflation. However, as indicated by the staff, important signs of progress have begun to emerge as the fiscal deficit has been reduced, and inflation

has recently begun to decline. Those signs of progress should reinforce the country's commitment to reforms, since the ambitious strategy has already begun to bear fruit.

At this stage of the reform process, inflation appears to be one of the major problems facing the authorities. A further substantial attack on inflation seems required, in order to stabilize expectations and create a favorable environment for the expansion of the economy, and to limit the social and economic costs of adjustment. At the same time, the issue of unemployment deserves the careful attention of policymakers. A persistently high and rising unemployment rate may weaken the political and social consensus on reforms. Further action, particularly at the structural level, to improve labor market conditions is therefore called for.

Notwithstanding the significant improvements made in reducing the budget deficit in the last few years, a further reduction is necessary to support the adjustment process. A lower fiscal deficit is needed as a contribution to the objective of bringing the current account deficit into a sustainable position. That deficit, which is equal to 3.6 percent of GDP, appears relatively large, especially in view of the outstanding stock of external debt (55 percent of GDP, with a debt service ratio equal to 38.8 percent). A further reduction of the budget deficit is also required to support the anti-inflationary policy stance, which otherwise will have to rely mostly on monetary tightening. In that respect, the New Zealand dollar has been appreciating strongly in the last few years, both in nominal and real terms, due to a large extent to the relatively high level of domestic real interest rates. Reducing the net dissavings of the public sector will help lower interest rates, and will contribute to increasing fixed investments and to fostering new employment opportunities. The beneficial effects of a tight fiscal stance are highlighted in Scenario B of the staff's medium-term projections. That scenario points to a better growth performance of the economy if a restrictive monetary policy were to be combined with the achievement of a budget surplus by the early 1990s. After the repeated revenue-raising measures taken in the recent past, and given the far-reaching scope of the recent tax reform, it is advisable to seek a lower public deficit by reducing the volume of expenditures, while making them more cost effective.

Monetary policy will have to continue to be aimed primarily at curbing inflation and lowering inflationary expectations. In that respect, the tightening of monetary policy in the last few years seems justified. In an economy like that of New Zealand, which is experiencing significant changes in its financial structure while a process of disinflation is unfolding, the monetary authorities can face a rapid weakening of the effectiveness of their traditional policy indicators. At present, "primary liquidity" is the authorities' main operating target and indicator. Given its narrow coverage, it is likely that the effectiveness of primary liquidity as an indicator will be lessened as the process of financial innovation proceeds and inflation is reduced. Moreover, the demand for primary liquidity seems subject to large fluctuations, which makes the stance of monetary policy difficult to assess over the very short term. All things considered, there is a need to carefully monitor the effectiveness of that policy indicator, and to stand ready to take prompt corrective action if necessary. Therefore, I welcome the pragmatic attitude of the Reserve Bank, which envisages attaching more importance to developments in other monetary aggregates, such as in M3, in due time. As indicated by the staff, monetary management could also be simplified by reducing the impact on primary liquidity of the operations the Reserve Bank performs for the Treasury.

Structural reforms appear to be having significant effects upon the economic system, particularly in the agricultural sector, as shown by the large gains in efficiency and value added summarized in Table 3 of the staff report. That table also highlights the relevant transitory costs of the reform process in terms of reduced employment.

Labor market performance is expected to remain weak in the coming year: labor shedding will continue, and unemployment is likely to increase. The correction of macroeconomic imbalances normally entails significant adjustment costs in terms of employment over the short run. However, those costs can be minimized by improving the responsiveness of real wages at the aggregate level to the difficult employment conditions, and by increasing the flexibility of relative wages across sectors. To that end, the approval in 1987 of the new Labor Relations Act seems to be a step in the direction of improving the framework of industrial relations and the functioning of the labor market. At the same time, it must be mentioned that the authorities themselves recognize that the Act does not go far enough in promoting labor market and wage flexibility. Therefore, the authorities should maintain the momentum of labor market reform in order to achieve the adjustment targets they have set for the economy.

Mr. Fogelholm made the following statement:

I would like to join other Directors in commending the authorities for their firm and persistent efforts to restructure the economy despite the lack of immediate positive results. I generally concur with the staff assessment.

The authorities have made some bold moves in restructuring industrial relations, and deserve credit for their efforts to increase the flexibility of the labor market. However, the slow speed at which those reforms have generated employment opportunities seems to indicate that the reforms were not sufficiently far-reaching. Consequently, I agree with the staff that the framework of labor relations should be reviewed once more. The relatively high and still rising level of unemployment is certainly disappointing, particularly in view of the fact that real wages have been declining over the past years.

As regards the upcoming wage round, I believe that the Government is well advised to continue its approach of not becoming directly involved in the negotiation process. Therefore, I would be curious to know what kind of "reasonable efforts by the Government to help ensure an appropriate outcome" (SM/88/115, page 19) the staff has in mind. It would seem that a formal or informal announcement by the Government that it would counter excessive wage settlements, through fiscal policy measures, for example, would be one way the Government could indirectly influence the outcome of the negotiations. Could the staff or Mr. Sliper comment on the state of the wage negotiations, and on whether there really are reasons to expect an inflationary wage settlement in a situation of high unemployment and economic slack?

The authorities should be commended for the progress they have made in their fiscal policies over the past few years, both in terms of reducing the fiscal deficit and in pursuing fiscal structural reforms. Despite those achievements, it appears that further strengthening of the fiscal stance is required over the medium term. As Mr. Sliper stated, the authorities are fully aware that emphasis must now be placed on the expenditure side, even if the room for maneuver is limited in present economic circumstances. One should not, however, rule out revenue increasing measures either, in particular, measures that offset the increase in wages. Selling assets certainly strengthens temporarily the cash position of the public sector, but the major benefits to be garnered over time from that policy, I believe, are the efficiency gains realized by those enterprises which have been privatized.

Fiscal consolidation also comes to the fore when the currently fairly restrictive monetary policy is reviewed, due to the fact that the Government's large borrowing requirements have been instrumental in keeping interest rates high and, consequently, the dollar strong. The high real interest rates and the strong New Zealand dollar have no doubt weakened competitiveness and slowed investment by industry. Therefore, a further tightening of monetary policy to contain inflation does not appear to be feasible; yet despite high interest rates, there is still a strong demand for credit in the household sector for consumption purposes, which would suggest that the economy continues to perform as if it were in a high inflation cycle. A more lax monetary policy stance is thus largely out of the question, and the authorities continue to face a policy dilemma, as many Directors have noted. The only room for maneuver appears to be on the fiscal side, and I believe that the correction of the fiscal imbalance, even though small in an international comparison, should be given the highest priority by the authorities.

This chair fully supports the staff's recommendation of placing New Zealand on the bicyclic consultation procedure.

Mr. Seyler, elaborating upon his statement, said that even in a country with a freely-floating currency, the monetary authorities usually referred to a basket of currencies of the country's main trading partners, so that it was still possible to speak of an appreciation or a depreciation. Mr. Enoch had referred to the currency depreciation undertaken by Belgium, and had advised the New Zealand authorities to follow a strong currency policy. In the case of Belgium, there had been a depreciation followed by a strong currency policy, but the strong currency policy had meant in that case a stable rather than an appreciating currency. In the case of New Zealand, depreciation had been followed by appreciation, which was quite different.

The staff representative from the European Department noted that the 40 percent real appreciation of the New Zealand dollar which had occurred subsequent to the devaluation of July 1984 had been mainly the result of changes in relative prices, rather than of a nominal exchange rate appreciation. In nominal effective terms, the appreciation had been quite modest; perhaps 5 percent out of the 40 percentage points had been due to the nominal exchange rate appreciation. A major debate within New Zealand was proceeding about the exchange rate and the targeting of monetary policy. As a matter of interest, the farmers, who represented the main export sector of the New Zealand economy had concurred with the Government's approach, and had emphasized that a reduction in inflation was a prerequisite for a durable improvement in the ability of exporters to compete in world markets.

The Chairman observed that the appreciation of the New Zealand dollar by 40 percent needed to be viewed in conjunction with the 30 percent depreciation of the Australian dollar, the currency of a country which was one of New Zealand's major trading partners.

The staff representative of the European Department recalled that Mr. Enoch had raised the issue of tax reform and the role of the capital gains tax. The Finance Minister had publicly indicated his interest in the capital gains tax, and had pointed out the logic of including a capital gains tax in the overall tax reform strategy, because of the desirable impact of such a tax on the closing of loopholes, the promotion of neutrality, and the broadening of the tax base.

Mr. Templeman stated that the United States had experienced a significant appreciation of its currency in the face of current account deficits. Capital flows had been a major factor in the appreciation of the U.S. dollar, and he had been particularly struck by the fact that not much seemed to be known about the impact of capital flows on the balance of payments in the case of New Zealand. It would be interesting to know if anything could be said about that, in particular, whether there had been very large compensatory borrowing in New Zealand.

The staff representative from the European Department replied that very little was known about private capital movements, although the Government's role in capital transactions was known. The financial liberalization in New Zealand had left an enormous gap in the statistical framework, because the controls which had previously existed on the financial system had been used as a data collecting mechanism as well. The authorities were aware of that gap, but were unsure whether it could be eliminated quickly.

The tightening of monetary policy which had occurred prior to the stock market reversal of October 1987 might have suggested that an economic downturn would be on its way whether or not the stock market reversal had occurred, so that Mr. Enoch's comment that the effect of the reversal on the New Zealand economy might have been overstated could be correct, the staff representative observed. That notwithstanding, the stock market reversal in New Zealand had been larger than in most markets, as about 50 percent of asset values had been immediately wiped out. The econometric evidence was that such a decline in asset values could have reduced growth by about 1 percentage point. Also, the market reversal had attacked the most dynamic and growing economic sector, the financial sector. The staff had expected growth in New Zealand to tail off much earlier, but it had been sustained because the financial liberalization had developed dynamism in the economy at large. The stock market reversal had had quick negative effects on expectations, because confidence in New Zealand had already been fragile, for many reasons.

Several Directors had raised the question of the most desirable anchor for monetary policy, the staff representative recalled. In an inflationary environment, it was difficult to interpret the stance of monetary policy by observing interest rates. In a changing structural and fiscal environment, confidence swings were large, making the use of short-term movements in exchange rates as a measure of the tightness of monetary policy unreliable. Financial liberalization had also made the monetary aggregates difficult to interpret. Given those difficulties, in the short-term it was advisable for the authorities to pay particular attention to the yield gap between short- and long-term interest rates, because both rates had incorporated into them some element of inflationary expectations. The view in New Zealand was that the yield curve needed to be inverted in order to fight inflation; how steeply inverted it needed to be was a matter of judgment which changed with the circumstances. As a rule of thumb, both the authorities and the staff believed that a negative yield gap of several percentage points was necessary. Such a gap had in fact existed in recent months, and was the basis for the staff's view that monetary conditions had been reasonably tight. Once the financial liberalization was sufficiently in the past, monetary aggregates could be looked at as an anchor for monetary policy with more confidence. The authorities hoped that that time would come soon.

Interest rates and the effects of confidence were, in the staff's view, the fundamental explanation behind the appreciation of the exchange rate, the staff representative went on. The impact of interest rates on the exchange rate was seen as of particular importance by the staff, although the authorities saw the effects of confidence as of greater importance. The thoroughgoing and logical approach to economic policy in New Zealand had undoubtedly struck a chord in international financial markets, encouraging an exchange rate appreciation which was, however, to New Zealand's competitive disadvantage.

Investments with high-coupon rates of return in industrial countries like New Zealand were particularly attractive to some foreign investors for portfolio and tax reasons, the staff representative continued, which explained the attractiveness of foreign investment not only in New Zealand but also in Australia. As there were close ties between Australia and New Zealand, financial investments in the two countries undoubtedly looked very similar to foreign investors. Also, the strengthening of the Australian dollar had had some indirect effects upon New Zealand, and the improved level of confidence in Australian investments had also enhanced confidence in New Zealand's investments, even though circumstances in New Zealand had not changed.

Import liberalization and the removal of protective policies had been uneven among the major sectors of the economy, the staff representative observed. Protection for the agricultural sector had been removed very rapidly--in fact, the subsidies for agriculture and export industries had been removed almost overnight--whereas the manufacturing sector had been treated more gently. Even within the manufacturing sector, the pace of import liberalization had been uneven, with more caution toward liberalization in sensitive areas covered by industry plans. It was the staff's view that more rapid liberalization of industries covered by industry plans to bring them within the overall framework of protection would be of great benefit. The authorities were proposing to reduce tariffs by about half over the next four years. Although the staff would certainly prefer a faster pace, a faster pace at a point of economic weakness and rising unemployment would be very difficult for the authorities.

One Director had raised the question of the elasticity of New Zealand's exports to price changes, the staff representative went on. New Zealand's agricultural sector, which accounted for an important part of its exports, was one of the most efficient and dynamic in the world, and had shown its ability to respond very rapidly to price and market signals. Even in the current difficult circumstances facing agriculture, the traditional industries, such as sheep raising and the meat and dairy industries, were slowly giving way to horticulture, and the raising of goats and deer, because of those price signals. However, the adverse effects of the general economic conditions of the past few years on agriculture had been reflected in cutbacks in agricultural incomes of 56 percent over the past four years, and profitability in agriculture had clearly been weakened.

Another Director had raised the issue of what the staff had meant by referring to the Government's reasonable efforts to influence the outcome of wage negotiations, the staff representative concluded. What the staff had had in mind had been described very nicely by Mr. Grosche, that the Government could remind the social partners of their responsibilities. The Finance Minister had in fact written to both the unions and the employees in the previous month with that object in mind.

Mr. Templeman observed that the next time the Board reviewed the bicyclic consultation procedure it might be useful to examine the types of countries that were choosing to be placed on that schedule. He had observed a pattern recently emerging whereby some of the smaller industrial countries had expressed an interest in switching to the bicyclic consultation schedule; for example, Denmark, Ireland, Israel, and currently, New Zealand. There seemed to be resistance to the bicyclic consultation schedule, however, among some of the smaller industrial countries whose economic problems were not serious. It would be helpful if Directors could learn the reasons behind a country's selection or rejection of the bicyclic schedule after it was proposed by the staff. His chair would not stand in the way of allowing New Zealand to go onto the bicyclic consultation schedule if it chose to.

The Deputy Director of the Exchange and Trade Relations Department remarked that while the review of surveillance had been made biannual, a statistical presentation would be made of the countries that were on the two cycles. The Board could discuss the matter on the basis of that presentation if it desired. Generally, the staff would recommend that only those countries that were performing well and whose prospects were clear be moved onto the bicyclic consultation schedule. There was, however, a gray area into which many countries fell. Although there were important questions about developments in New Zealand, those developments did not fall within the category of serious concerns about the external sector that was the criterion for excluding countries from the bicyclic consultation schedule. If the bicyclic schedule was going to be used broadly, it would be necessary to include in it countries like New Zealand, otherwise its application would be so narrow that the time savings for both the Board and the staff would not be meaningful.

Mr. Sliper stated that the conjunction of events and policies in New Zealand raised some fascinating questions about the adjustment process and the blend of macroeconomic and microeconomic policies. The question of the role of monetary policy, and to what extent the mastering of inflation should prevail over external concerns, alluded to by Mr. Seyler, greatly depended on the inflation history of a country and upon the institutional framework, in his view. He had been recently reminded of the U.K. experience with very high inflation in 1981-82, when the U.K. authorities had been faced with the dilemma of gearing their monetary policy either to controlling inflation or to reacting to the appreciation of the pound sterling. The U.K. authorities had also decided that mastering inflation must be the primary concern. Clearly, there was concern in New Zealand about the rising exchange rate, but inflation had become so deeply embedded that its winding down remained the absolute priority. For that reason, he concurred with the views of the majority of Directors that the New Zealand authorities should maintain tight control of monetary policy but should perhaps move more on fiscal policy, and, in particular, on labor market policies and import liberalization.

The recommendation made by Mr. Seyler that New Zealand implement a shock treatment for the exchange rate devaluation would require the concomitant implementation of capital controls, or something quite like them, which raised serious questions, Mr. Sliper commented. Mr. Seyler had also suggested that the central bank issue noninterest bearing securities, which would also require some form of controls over financial institutions. Such controls had been tried in New Zealand in the past but had not been very successful. They lacked transparency and were found to be inefficient from a financial intermediation point of view, and in effect they constituted a tax on those institutions which invested in the low yielding securities.

The Minister of Finance and the Government were committed to introducing a capital gains tax, Mr. Sliper went on, and the Minister of Finance had gathered information about the capital gains taxes of other industrial countries. It was clear that no system was perfect, given the administrative effort that would be needed to gain the revenue and the practical implementation problems. The capital gains tax was viewed as an adjunct to the tax reforms that had already been enacted.

Efficiency was the goal behind asset sales, Mr. Sliper commented. Those sales had been accompanied by a reduction of monopoly controls that had protected the public enterprises, especially in telecommunications. Another goal of the asset sales was the reduction of the public debt.

The comment by the Minister of Finance that he did not expect any improvement in the fiscal position for 1988 was actually a public statement that needed to be seen in the context of the struggle over the budget currently taking place between the Finance Minister and the ministers responsible for spending, Mr. Sliper concluded. The authorities were hopeful of some modest reduction in the fiscal deficit in the medium term, and they were certainly looking for deficit reduction in the longer term. They had publicly stated that they were seeking a fiscal surplus for the early 1990s.

The Chairman then made the following summing up:

Executive Directors commended the authorities on the continued determination which they had shown in implementing their program of stabilization and structural reform. Signs of progress in reducing imbalances had become evident, especially the downward trend in inflation, while the effects of restructuring had become more widespread. While restructuring had, in large part, been carried out, the economy's response to the new environment had been slow. Growth had stagnated and unemployment was rising, while significant macroeconomic imbalances persisted.

Directors welcomed the continued policy efforts that had yielded progress in reducing inflation. However, they shared with the authorities the view that, especially because inflation in New Zealand remained well above that in most other industrial countries, first priority should continue to be given to further reducing inflation, so as to provide a strong foundation for future growth. Directors generally welcomed the firmer and more consistent stance of monetary policy over the past year, and recommended that the tight stance of monetary policy be maintained. They also emphasized the desirability of obtaining a moderate outcome to the next wage round, toward a consolidation of the declining trend in inflation in the period ahead.

Directors welcomed the improvement in the fiscal balance of recent years, which had been carried further in 1987/88. The improved fiscal position had contributed to a significant reduction in interest rates over the past year. They strongly supported the authorities' intention to achieve a further strengthening of the fiscal position now and in the coming years. Directors noted that the improvement in the fiscal position so far was mainly on the revenue side, and that future efforts should concentrate on reducing expenditure. In those efforts, a rationalization of spending on social programs, which was currently under review, could play a significant part. The recent tax reform measures, which further broadened the tax base, reduced tax rates, and promoted neutrality, were seen as a significant step forward. The authorities' initiative to sell public assets to retire public debt was welcomed as a useful step which would increase fiscal flexibility and improve overall efficiency.

Directors took note of the new legislation that was aimed at increasing flexibility in the labor market, but believed that further measures to improve labor market flexibility and efficient adjustment were desirable, in view of the limited effect such legislation had had so far. Both the recent steps and the future plans to lower import barriers were welcomed, but Directors believed that more rapid progress in that direction would assist the adjustment effort.

At the same time, Directors expressed concern about the costs that had been associated with the adjustment program. They especially noted the weakening of economic activity in 1987 and 1988, which had been accompanied by a sharp increase in unemployment and a sustained strengthening of the New Zealand dollar. The strengthened currency was seen as putting pressure on the export and import-competing sectors, against the background of a persistent external current account deficit and a large external debt burden. However, most Directors believed that government action to devalue the currency would not be the appropriate response in present circumstances, especially because such action would threaten the credibility of the Government's policy priority, which was the restoration of price stability. Instead, most Directors stressed the important role that could be played by strong measures to strengthen the fiscal position, which would help to ease pressures in financial markets and relieve some of the burden currently borne by monetary policy. They also drew attention to the significant actions that were currently taking place to improve competitiveness, as the effects of restructuring in New Zealand began to take hold.

Nevertheless, a few Directors were of the view that New Zealand's monetary and interest rate policy had been inconsistent with the need for a competitive exchange rate, and that a restructuring of the economy could not be expected to correct the recent large appreciation of the New Zealand dollar; taking into account the weakening of economic activity and the persistence of fiscal and external deficits, steps to bring about a substantial currency depreciation, with flanking measures, were thus called for by these Directors.

Directors agreed to place New Zealand on the bicyclic consultation procedure. It is expected that the next full Article IV consultation with New Zealand will be completed within 24 months.

2. SOMALIA - 1988 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1988 Article IV consultation with Somalia (SM/88/100, 5/3/88, and Sup. 1, 6/6/88). They also had before them a background paper on recent economic developments in Somalia (SM/88/106, 5/16/88, and Cor. 1, 6/6/88).

The staff representative from the African Department made the following statement:

> A staff team visited Mogadiscio last May, and reached a broad understanding with the Somali authorities on the exchange rate policy. On June 20, the Government of Somalia announced that the Somali shilling will be pegged to a basket of currencies representing the currencies of Somalia's main trading partners, and on the same day the Somali shilling was devalued by 44.4 percent in foreign currency terms. The initial valuation of the shilling in terms of the new basket yielded a rate of So. Sh. 180 = US$1, compared with the last prevailing official rate of So. Sh. 100 = US$1. The Government also announced that the price controls that were established in February 1988 will be reviewed, with emphasis given to the encouragement of production and exports, and to the removal of barriers that may discourage production and exports. On June 21, the Government paid SDR 148,000 toward clearing Somalia's overdue obligations to the Fund. A staff team will visit Somalia shortly to continue discussions on a set of adjustment measures in the areas of fiscal, monetary, and pricing policies to support the exchange rate action. The staff will keep the exchange rate under close review, and the authorities have been made aware that further adjustments in the rate would be required.

Mr. Finaish made the following statement:

> At the request of the Somali authorities, a staff mission visited Somalia during the second half of May in order to follow up on the policy discussions held in connection with the Article IV consultation. The focus of the discussions was on the key issue of exchange rate policy, as well as on the price-control measures which had been adopted last February. Important progress was achieved during the discussions, and a tentative agreement was reached on those two major issues.
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> The main elements of that agreement were: an initial devaluation of the exchange rate from So. Sh. 100 per U.S. dollar to So. Sh. 180 per U.S. dollar; the pegging of the shilling to a basket of currencies of Somalia's principal trading partners; a flexible exchange rate policy, including adjustments in the rate to reflect inflation differentials; the establishment of a new open and fair system of foreign exchange allocation; and a reconsideration of the price control regulations introduced last February with a view to removing them.
>
> I am pleased to inform the Board that following the endorsement of that agreement on the political level, a policy announcement was made by the Somali authorities on June 20 which

reflected the exchange rate and pricing policies outlined above. In the meantime, the price control regulations are not being enforced.

The authorities hope that the agreement with the Fund on key policy questions will mark a turning point for the Somali economy, and will constitute a beginning of a new and positive phase of collaboration with the Fund. The experience of the past ten months has been quite difficult, and the authorities are eager to resume the adjustment process which they had embarked upon a few years ago.

As Directors are aware, the objective of the 1987-88 adjustment program was to consolidate the adjustment gains achieved in the preceding two years, and to move the structural reform process forward with the support of a three-year arrangement under the structural adjustment facility. I will not dwell on the circumstances which led to the interruption of the stand-by arrangement, since I have addressed that issue on a number of occasions during the Board discussions of Somalia's arrears to the Fund. But it is important to recall that the arrangement entailed prior actions in key policy areas, and that performance in the initial period was satisfactory. However, the fragility of Somalia's financial position and delays in the disbursement of external assistance were quickly reflected in the foreign exchange auction, and the exchange rate began to depreciate rapidly due to the unavailability of foreign exchange resources to meet the rising demand. In the event, the authorities felt the need for emergency actions which, admittedly, represented a significant departure from the adjustment program. As I indicated during the Board discussion on Somalia last May (EBM/88/72, 5/6/88), even while adopting those emergency measures, the authorities recognized and explicitly stated that they were resorted to as a temporary response to an urgent situation; they also expressed their awareness that some of those measures did not represent a long-lasting solution to Somalia's problems, but were adopted temporarily pending agreement on the political level over the course of policy which can deal with the situation in a more effective and sustained fashion.

The experience of the past year again demonstrates how critical it is, in cases like Somalia where the room for maneuver is small, if not totally nonexistent, that the financial inflows on which the program is based be made available in a timely manner. Without a margin to absorb delays or shortfalls in external flows, such delays or shortfalls can easily spill over to all sectors of the economy, and make the task of policy implementation even more difficult than it already is. That is particularly so when a major element of the adjustment program is a foreign exchange auction system which can be very easily disrupted by the unavailability of timely flows of foreign exchange resources. While it is difficult to make a general inference about the merits of auction systems, it is perhaps worthwhile for the Fund to review the experience of members with such systems in order to understand better the possible risks and pitfalls they may entail in certain cases.

In early 1988 there was an intense political debate in Somalia on the appropriate course of economic policy, particularly in relation to the exchange system and pricing measures. In the meantime, in order to contain the mounting inflationary pressures and the large external imbalance associated with the decline in foreign exchange inflows, the authorities aimed at a substantial budget tightening in 1988, as was reflected in the fiscal targets for 1988. With the recent policy announcement I referred to earlier, there is now a strong basis for a comprehensive agreement with the staff on an adjustment program which could be endorsed by the Fund, and which would catalyze the much needed assistance from creditors and donors. The Somali authorities are eager to arrive at such an agreement, and have requested that a staff mission visit Somalia shortly for that purpose.

In addition to the exchange rate and pricing policies which have already been agreed upon, the adjustment program will obviously also cover fiscal policy and structural reform. With respect to fiscal policy, as I indicated earlier, the authorities are aiming at a significant budget tightening in 1988. Although information on the actual fiscal outcome so far this year is not yet available, the recent policy measures in the exchange rate and pricing areas should contribute to an improved fiscal performance for the year as a whole. With respect to the structural adjustment in general, the aim will be to resume the significant progress that had been achieved in previous years in liberalizing the economy. It should also be mentioned that during the first year of the 1987-89 structural adjustment program, which was supported by structural adjustment facility resources, a number of measures were taken to liberalize imports and the distribution of certain items. Also, in collaboration with the World Bank, steps were taken to liberalize domestic trade in hides and skins, promote private sector activity in agriculture, improve the management of food aid, and proceed with public enterprise reform. The authorities look forward to further support from the Bank and the Fund in the future for their structural adjustment program.

The authorities recognize that the financial involvement of the Fund will not be possible before the full settlement of overdue obligations. However, they consider the Fund's role in mobilizing support from creditors and donors, in the form and

> amounts needed, to be crucial for the success of their adjustment efforts in the period ahead. An adequate flow of external assistance will also be crucial for the regularization of Somalia's relations with the Fund. The authorities on their part will do everything they can to facilitate a full settlement of the arrears as soon as possible. Indeed, a partial payment was made to the Fund a few days ago. Given Somalia's external reserve position, this payment--though small--is indicative of the priority which the authorities attach to normalizing Somalia's relations with the Fund.

Mr. Finaish added that he had tried to focus on the future, which was why he had not taken issue with certain statements in the staff report, including the following: "It is a matter of serious concern that after five stand-by arrangements, the first having been approved by the Fund in 1980 and more than SDR 200 million of Fund resources made available to Somalia under this arrangement and other facilities, Somalia appears to have achieved little in terms of adjustment." It was true that the balance of payments situation in Somalia remained very difficult, and that the staff report had been written before the May discussions and the recent policy actions. Although those considerations perhaps explained the negative tone of the staff appraisal, the staff statement gave the impression that the Somali authorities had received financial assistance from the Fund without doing much in terms of pursuing adjustment policies in return. That was not the case, for the Fund's financial assistance was provided to members only on the basis of performance, and often, of prior actions. In fact, some Directors might recall that until 1984 Somalia had been considered one of the Fund's success stories. At that time, the Managing Director had cited Somalia in his public speeches as an example of successful adjustment.

In 1984, the Somali economy was faced with serious exogenous problems, including difficulties in marketing Somalia's main export, Mr. Finaish recalled. In 1985-86, the authorities had tried to adjust to those problems with the aid of a Fund-supported program, the outcome of which had been mixed, but significant progress had been achieved in a number of areas, nevertheless. The 1987 program had been intended to consolidate and strengthen the adjustment effort, again with the support of Fund and structural adjustment facility resources.

He had already addressed the circumstances which had led to the interruption of the stand-by arrangement, Mr. Finaish continued. One thing was clear from the experience of the last two or three years, namely, that the absence of a reasonable margin for maneuver in the adjustment program carried with it the risk of program interruption, particularly when the country had large debt obligations, including to the Fund, and when timely external inflows were a critical assumption of the program. In such circumstances, a small deviation could very easily disrupt the whole process. It was to be hoped that efforts would be made by all parties concerned, including the Fund, the Somali authorities, and Somalia's creditors and donors, to avoid that problem in the future.

The staff appraisal left the impression, although it was undoubtedly unintentional, that a shift in the orientation of the policies of Somalia had occurred, Mr. Finaish concluded. For example, there was a reference to economic decisions having been made after the meeting of the Revolutionary Socialist Party and subsequent changes in staff, and after the installation of the new economic policy team. The implication seemed to be that a major shift in the policy and orientation of the country had occurred, which was incorrect. With respect to the changes in staff, the new Minister of Finance had been the Minister of Foreign Affairs for about the previous ten years. The Governor of the Central Bank had been the President of the Development Bank, and the Minister who had negotiated most of the agreements in the 1980s with the Fund was now the Ambassador of Somalia to Washington. Consequently, in his view no revolutionary or basic changes had occurred in Somalia, and the process of adjustment was not being abandoned.

Mr. Dai stated that Somalia's Fund-supported adjustment program had unfortunately been interrupted in September 1987, for economic as well as political reasons. However, after ten difficult months, the authorities were now eager to resume the adjustment process which they had embarked upon a few years previously, and had requested that a Fund mission visit Somalia shortly for further negotiations, to formulate a comprehensive adjustment program.

The recent policy announcements made by the Somali authorities, and the partial repayment of Somalia's arrears to the Fund, were welcome gestures, Mr. Dai commented. His chair sincerely hoped that the Somali authorities would return resolutely to a path of sustained and credible adjustment. If the direction of the adjustment was believed to be correct and suitable to the specific circumstances of the economy, adherence to the established adjustment policies was advisable, even though there might be some risks in the process of adjustment and structural reform. What was of importance was that steady and realistic measures be implemented so that drastic setbacks could be avoided as much as possible. It was also to be hoped that creditors and donors would give their assistance to Somalia in a timely fashion in support of its adjustment efforts.

While he generally agreed with the thrust of the staff's recommendations, Mr. Dai went on, an overall review of the adjustment program in Somalia, based on a thorough evaluation of past experiences and lessons, would be desirable. He fully agreed that in a country like Somalia, the room for maneuver was small. He noted that the economic situation in Somalia was very difficult, with a very high debt service ratio, of over 100 percent, and very low official foreign reserves--the equivalent of less than two weeks of imports. The fragility of its financial position, vulnerability to exogenous factors, and heavy reliance on external assistance, made the task of policy implementation for Somalia difficult. With that in mind, he wondered what were the causes of the disruption of the adjustment program, especially the abandonment of the foreign exchange auction system in September 1987. Whatever the reasons, whether due to the unavailability of timely flows of foreign exchange resources, as Mr. Finaish had suggested, or whether it was because the authorities had been alarmed by the sharp depreciation which had occurred on September 16, as described in the staff report, he agreed with Mr. Finaish that a review by the Fund of members' experiences with foreign exchange auction systems might perhaps be worthwhile.

Mr. Al-Assaf stated that Somalia was one of the poorest countries in Africa, with a very limited export base, which caused the total of export earnings to be well below the total of import costs. Nevertheless, Somalia possessed some potential in the agricultural sector, particularly in cotton cultivation and fishing. The realization of that potential, along with the improvement in the performance of other sectors, would be a long, tedious, and complex process.

Against that background, his chair warmly welcomed the adjustment effort initiated in 1985, which had been further strengthened in 1987 with a Fund-supported program, Mr. Al-Assaf continued. The authorities had begun to transform the economy from one with excessive controls into one with a greater market orientation. As a result, an appropriate exchange rate policy had been promoted, inflation had decreased significantly, and the overall fiscal balance had improved; those were clearly commendable developments.

The reversal of that encouraging policy stance was a cause for concern, Mr. Al-Assaf commented. The overall deficit on a commitment basis had doubled in terms of GDP, new external arrears had accumulated, revenues had stagnated, and inflation had increased significantly, while the real effective exchange rate had appreciated by 77 percent. It was heartening to note from Mr. Finaish's statement that those setbacks represented only a temporary reversal of the authorities' commitment to far-reaching and comprehensive adjustment.

He had been encouraged by the new policy actions described by Mr. Finaish, including the decision to reconsider the recently imposed price controls, the devaluation of the Somali shilling, and the authorities' intention to pursue a flexible exchange rate policy that took into account the inflation differential with Somalia's trading partners, Mr. Al-Assaf went on. He agreed with Mr. Finaish that perhaps the time had come for the Fund to review its experience with the foreign exchange auction system. While the new policy actions were welcome developments, the consolidation of the government bureaucracy, and the attempt to control overall credit expansion by strengthening the collection processes of the commercial bank, were both warranted. Those steps were predicated upon an improvement in the authorities' data collection capabilities, and technical assistance from the Fund in that respect might be appropriate. A tightening of the monetary policy stance was also clearly needed.

If the policy actions were to be successful, Mr. Al-Assaf observed, they would need to be implemented within an overall framework of a comprehensive and far-reaching adjustment program. A Fund-supported program could not be agreed before Somalia's arrears to the Fund had been removed. While he welcomed the small payment Somalia had made recently to the Fund, it was evident that the arrears constituted a burden on other members. He was encouraged that the authorities attached high priority to normalizing their financial relations with the Fund, as Mr. Finaish had stated. In the meantime, he welcomed the authorities' intention to pursue a shadow program, and he hoped, as suggested by Chancellor Lawson of the United Kingdom, that in the future the period of such a program would be counted in any arrangement under the structural adjustment facility or enhanced structural adjustment facility, so that the program could be retroactively financed in the event such an arrangement was concluded.

Even in the best of circumstances, the medium-term prospects for Somalia would remain difficult, Mr. Al-Assaf remarked. The economy would remain vulnerable to fluctuations in weather conditions and dependent on external financing. He agreed with Mr. Finaish that the delay in the provision of external financing had been a major impetus to the failure of the program which had been initiated in 1987. Nevertheless, it was crucial for the authorities to maintain stable and consistent policies directed at far-reaching and comprehensive adjustment.

In one of the Board's previous reviews of Somalia's overdue payments earlier in the year, he had been among those who had requested that the new economic team in Somalia be given more time to adopt the appropriate policies, Mr. Al-Assaf recalled. He was glad that the team had not disappointed him.

Mr. Hogeweg made the following statement:

> I very much welcome the message of the staff representative from the African Department this morning, which was also conveyed in more detail by Mr. Finaish. That message is an important update of the staff report.
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> I am glad to join previous speakers in commending the authorities for their new intentions, which indicate that they have returned from their regrettable experiments in 1987, which led to the abandonment of the Fund-supported program. In response to Mr. Finaish's observations, although the authorities have perhaps not shifted their aims, I believe that they have shifted their methods in an important way. Although the Board should perhaps not dwell too long on the past, the damage which was done in that episode also should not be lost sight of; in the staff's assessment, it is likely to have a very detrimental effect on Somalia's economic prospects in 1988 and in the medium term. I have the impression that no one really knows what happened to government expenditures in late 1987. In Somalia, as elsewhere, it appears that even a relatively short reversal

of policy direction away from a comprehensive adjustment effort can undo the effects of years of good policies. I am afraid that that in no way helps to avoid adjustment fatigue.

As for whether it might perhaps be worthwhile to conduct a review of the experience with foreign exchange auction systems, because they can be easily disrupted by the unavailability of timely flows of foreign exchange resources, I have noted that previous speakers have joined Mr. Finaish in expressing interest in such a review. I too would appreciate staff comments on that suggestion, especially because the staff itself has indicated in the report, and to the authorities, that the abandonment of the auction system as such would not have posed an insurmountable problem for the program had it not been replaced by a sizable appreciation and subsequent rigid management of the exchange rate.

In comparing the tentative agreement which has now been reached with the elements of a comprehensive program mentioned on page 19 of the staff report, it seems that steps are being taken toward a realistic exchange rate policy and toward free market pricing. However, the required measures to strengthen budget policy, including a reduction of the budget deficit, do not seem to go much beyond a statement of good intentions, and I do not know whether those intentions go far enough. The problem of the weakness of the data base will also have to be addressed, as well as the apparent deterioration in the authorities' capacity to ensure the implementation of agreed policies, which in the staff's view would require extensive technical assistance. I understand that extensive personnel changes at the senior and middle management levels are contributing to those problems.

I am certainly glad that the authorities of Somalia realize that they must return to the basic characteristics of the program they once abandoned, but it will take time and effort to undo the damage which has been done. In the meantime, and I think this is a very important point, it is very dangerous at this stage to implement part of a comprehensive program, especially the devaluation, while the necessary complement of domestic demand management is not yet in place. Let us hope for the best.

Mr. Zecchini made the following statement:

The recent evolution of the economy and economic policies of Somalia is rich in contrasts with respect to the policy orientation of the authorities and the economic results of the last few years. Wavering adherence to the strategy for correcting the external and internal imbalances and for structural reforms has produced unsatisfactory results so far. As a consequence, Somalia is still struggling with difficult adjustment problems, in addition to the long-standing weaknesses of its economy. The longer the correction of those problems is delayed, the larger they will become, and the more unpleasant the solutions will need to be.

Before abandoning the adjustment program, Somalia was slowly but surely beginning to correct the external and internal imbalances. The stand-by arrangement and the arrangement under the structural adjustment facility were originally granted because it was deemed necessary to consolidate the good results that had been achieved initially, and to strengthen Somalia's determination to deal with its adjustment problems.

Somalia's shift in policy, which started during the second half of 1987, has resulted in a rapid worsening of the economic situation, leading to a dissipation of the hard-earned improvements initially recorded. The shift in policy and consequent disappointing results have considerably reduced the international community's confidence in Somalia's policies, thereby lessening the Government's ability to attract the external financial support which is essential for a balanced development of the economy over the long term.

The Government's decision to abandon the program was followed by highly expansionary fiscal and monetary policies, the introduction of unwarranted price controls, and the revaluation of the exchange rate to an uncompetitive level. At the same time, revenue decreased mainly as a consequence of the relaxation of tax administration, the external position seriously deteriorated, and the arrears situation gradually worsened, until Somalia was ultimately declared ineligible to use the Fund's resources.

In the face of such difficulties, the authorities have recently adopted some corrective measures which appear oriented to deal with short-term macroeconomic stabilization, rather than with long-term imbalances and weaknesses. The devaluation of the currency to So. Sh. 180 per U.S. dollar, the innovations in foreign exchange allocation, and the authorities' intention to eliminate price controls, are steps in the right direction, but are obviously not sufficient to redress the current economic predicament. More far-reaching measures need to be implemented in the coming months and pursued with determination in the next two years, both in the areas of financial policy and of structural reforms.

In the first area, tight control over monetary and credit expansion is necessary, since it is evident that in the last 12 months the authorities have lost control over the dynamics of those two sets of variables. In the fiscal area, a drastic cut in the public sector's dissaving is urgent, and should be achieved by both reducing public expenditures and enhancing tax revenues. In that respect, a reduction of tax evasion and a broadening of the tax base are preferable to sharp increases in tax rates or in external tariffs. Furthermore, substantial improvements in the monitoring of the public budget accounts are essential, in order to give the authorities a clear view of their policy stance at an early stage, and to allow them to react promptly to deviations from the intended course. As to external policy, future exchange rate movements, as well as the system for exchange rate determination, should be in line with the need to restore and preserve an adequate degree of external competitiveness.

On the structural side of the economy, it is evident that the systems of price determination and of financial intermediation need extensive reforms, to promote an expansion of the production base and to ease the financing of profitable fixed investment. The system of foreign exchange allocation should be geared to the same end. In all those areas of weakness and reform, the authorities could benefit from outside technical assistance, which this chair strongly supports.

It is too early to conclude at present that the authorities, after taking the recent adjustment measures, are fully committed to pursuing with determination the multiyear strategy that is needed to achieve durable improvements in the economy in the near future. If that is in fact the authorities' commitment, I am sure that external financial support will be provided by the Fund, and by donor countries, in adequate amounts. If that is not the authorities' commitment, doubts about the appropriate use of external resources will make it extremely difficult to mobilize badly needed external financing.

Mr. Kleine commented that the staff's statement and that of Mr. Finaish had alleviated to some extent his deep concerns about the unsatisfactory economic outlook for Somalia, as it appeared that the Somali authorities were willing to return to an orderly adjustment path. Nevertheless, he assumed that the basic problems reported in the staff papers remained broadly unchanged.

When reviewing Somalia's relations with the Fund, Mr. Kleine continued, he could not but agree with the staff's assessment that "it is a matter of serious concern that after five stand-by arrangements, the first having been approved by the Fund in 1980, and more than SDR 200 million of Fund resources made available to Somalia under these arrangements and other facilities, Somalia appears to have achieved little in terms of adjustment." Such a state of affairs was very disappointing, the more so since the Board had repeatedly advised the Somali authorities that the only viable solution to the country's economic problems was the adoption and sustained implementation of a major reform package that was credible and could be supported by the international community through additional aid and debt relief. In that regard, he cautioned that the view that donors would feel enthusiastic about resuming disbursements on the basis of the measures taken so far was a misperception. The implementation of policies in the piecemeal manner of the past had not borne fruit, and a similar approach was unlikely to succeed under present circumstances.

An effective program of policy reform must encompass several key elements, Mr. Kleine stated. The most important of those would be the adoption of a flexible and realistic exchange rate policy. Such a policy should, as a first important step, reverse the considerable appreciation that had occurred since September 1987, so as to improve the competitiveness of tradable goods and return exports to official channels. He was therefore encouraged by the indications in Mr. Finaish's statement in that respect, but he did not know whether the devaluation of the exchange rate of June 20, 1988 would be sufficient to restore it to the level which had prevailed in September 1987.

It was also of great importance, Mr. Kleine observed, that the domestic resource imbalances be reduced by tackling the structural weaknesses of the government budget. Furthermore, the prompt introduction of measures to bring down the excessive expansion of domestic credit, and the establishment of positive real interest rates, should be high on the economic agenda. It was indispensable for an economic program in Somalia to correct the severe distortions in the price structure and to improve resource allocation. A prompt removal of the price control regulations would make an important contribution to restoring confidence among market participants about the Government's future policy orientation.

It was certainly most appropriate that the staff was willing to assist the authorities in their efforts to develop a comprehensive package of economic policies, and to offer technical assistance in policy implementation as well. A credible shadow program could help the Somali authorities to mobilize the necessary international assistance to clear Somalia's growing arrears to the Fund. In conclusion, it would be in Somalia's own best interest to formulate and implement a comprehensive economic program which would put the country back on a path of orderly adjustment.

Mrs. Walker made the following statement:

> This chair welcomes the opportunity to discuss Somalia's economy in more detail than was possible during the recent meeting on Somalia's overdue financial obligations to the Fund (EBM/88/72, 5/6/88). My authorities came away from reading the staff report with some feelings of despair over Somalia's situation and the prospects for improvement in the near future. In contrast, they read with interest Mr. Finaish's statement, in which he related a series of important actions that the Somali

authorities have recently taken. His statement was supported by the staff statement. Those actions are clearly a positive and welcome first step forward in Somalia's efforts to resolve its economic and financial difficulties. They appear to signal a change in the authorities' attitude toward collaboration with the Fund and other donors, by demonstrating their willingness to begin to tackle again the serious problems in their economy. I take note of Mr. Finaish's statement regarding the impression of change; one must acknowledge, however, that regardless of the reason, a change in the direction of economic policies has taken place since last fall.

The statement by Mr. Finaish that the authorities are eager to resume the adjustment process which was abandoned last fall is welcome. This chair hopes that that attitude will continue in the face of the difficult road ahead, and looks forward to continued action by the authorities on a number of fronts in the context of a comprehensive program, so that a longer-term solution to Somalia's underlying balance of payments problems can be found. However, such an effort will require a strong and comprehensive adjustment program that will be difficult to implement. The full resolve and political commitment of the Somali authorities will be required if measures with the scope and depth necessary to fundamentally improve the economy in the medium term are to be adopted; and sacrifices will be needed. But if the authorities can demonstrate their resolve through concrete actions in the months ahead, the donor community will undoubtedly reflect upon the appropriateness of their current attitudes toward external aid flows to Somalia. Those actions will be needed so that the loss of confidence in the adjustment process in Somalia that has resulted because of the slippages in the program last year can be reversed.

The specific measures that have been adopted so far go in the right direction overall, and are a first step in a difficult process of adjustment. The exchange rate action is welcome, particularly the commitment to manage the exchange rate flexibly, which will entail further discrete adjustments of the exchange rate, in the view of this chair. The staff has made the authorities aware of the need for further adjustment in the exchange rate. Given the problems which arose in implementing the previous foreign exchange auction system, we hope that the new auction system will better suit Somalia's situation. The reduced reliance on pricing controls currently under way is welcome, and the authorities are urged to eliminate such controls completely.

The exchange rate and pricing policy actions that have been taken, however, should be complemented with strong and supportive demand-management policies in the context of an overall comprehensive program. A significant improvement in the fiscal situation, supported by tight credit policy, will be an essential part of the adjustment program. The authorities' commitment to aim at a significant budget tightening in 1988 is welcome, but it appears that a financing gap of 1.2 percent of GDP will arise even if the current plan can be implemented. If the goal of financing the entire budget deficit from external sources is to be met, which my authorities think is a useful goal, then additional efforts may be needed to eliminate that gap. This chair would expect that the staff would undertake further work on fiscal policy during the next mission.

Efforts to implement the structural reforms started last year should be continued, so as to further the liberalization of the economy. While the exchange rate and demand-management policies should contribute to that effort, my authorities would look for the continued involvement of the World Bank, in conjunction with the Fund, in the areas of agriculture, trade liberalization, and public enterprise reform. I would be interested in hearing a status report on relations between the World Bank and Somalia, and how that relationship is linked with Somalia's plans to clear its arrears to the Fund and adopt a program of adjustment. Coordination with the World Bank will clearly be important in such a difficult case.

My authorities recognize that the Somali authorities have taken a very positive step in announcing the recent exchange rate and pricing actions. But that is only one step in what will need to be a more comprehensive process. In the meantime, Somalia remains in arrears to the Fund. Those arrears are placing a burden on other countries which also face difficult situations, and yet which remain current with the Fund. While this chair welcomes the recent small payment made by Somalia, clearance of the arrears as soon as possible will be important, so that Somalia can resume normal relations with the Fund. In that regard, I understand that there was some discussion of a working group on Somalia at the Board meeting on Somalia's overdue financial obligations. This chair believes that the establishment of such a group would be useful.

My authorities understand the Somali authorities' desire to seek the Fund's assistance in mobilizing the needed support of creditors and donors in favor of Somalia's adjustment efforts. The Fund's ability to assist in that effort, and Somalia's ability to mobilize external support, however, clearly rest on the convincing demonstration by the authorities of their resolve to continue implementing the adjustment program. This chair urges the authorities to build on the momentum created by the recent actions and move ahead with the adjustment program. In that regard, this chair looks forward to hearing further positive results after the staff mission returns from Somalia.

Mr. Ismael made the following statement:

It was unfortunate that the Somali authorities had felt compelled to abandon the original adjustment program. Looking back, one might ask whether the program was not too ambitious, given Somalia's social and political circumstances. As Mr. Finaish notes, the program did not leave the authorities any room for maneuver. When delays in external flows occurred, the foreign exchange auction system was disrupted. That, together with the social tensions that emerged, did not leave the authorities much choice but to let the program lapse. However, the authorities subsequently took some measures which contributed to a worsening of the situation. I was therefore pleased to read that the authorities are now taking steps which could lead to a resumption of the adjustment process. I particularly welcome the agreement reached on the issue of the exchange rate. I agree with Mr. Finaish and with other speakers that the Fund should review the experience of members with foreign exchange auction systems, in order to form a better understanding of the merits and risks of that approach.

I welcome the fact that tentative agreement has been reached between the Somali authorities and the Fund staff on key policy issues. The way could thus be paved for greater involvement of the Fund and other creditors in Somalia's adjustment efforts.

The measures that have been adopted in the fiscal and monetary areas should contribute to reversing the negative trend that has developed. However, policies must be tightened further, and steps should be taken to reduce the fiscal deficit to a more sustainable level. The decision not to enforce the price control regulations is also welcome, and I hope that those controls can be eliminated soon. But I would encourage the authorities to proceed with the implementation of a more comprehensive program which emphasizes both demand and supply-side measures so as to address the fundamental cause of imbalances, reduce price distortions, and improve resource allocation. However, it should be recognized that the success of any program of adjustment will continue to depend to a large extent on the timely disbursement of external financial assistance commensurate with Somalia's needs.

With regard to structural adjustment, I note that progress has been made toward the liberalization of markets and trade, the promotion of private sector activity, as well as the reform of the public enterprises. However, because of the serious imbalances that exist in the economy, the restructuring efforts will need to be maintained or even strengthened over the medium term, so that the economy's growth prospects can be improved and reliance on external assistance reduced.

> I welcome the partial payment by Somalia of its overdue financial obligations to the Fund. The full settlement of the arrears will certainly help in normalizing relations with the Fund, and will enable the Fund to lend its financial support to a full-fledged adjustment program.

Mr. Enoch stated that the recent policy adjustments announced by the Somali authorities were welcome, as was the small partial payment by Somalia of its overdue financial obligations to the Fund. Those actions represented a vital first step by the authorities in overcoming the very difficult circumstances facing Somalia, which were hard to exaggerate. The staff report had provided a depressing picture, and made sad reading. Somalia was a very poor country, vulnerable to many misfortunes. But what Somalia did not need were the policies the authorities had pursued after the abandonment in September 1987 of the last Fund-supported program. Those measures would be highly unlikely to do anything other than worsen Somalia's already precarious situation. The abandonment of the foreign exchange auction system was regrettable, but the relaxation of control over the economy to the extent witnessed in the last quarter of 1987 was alarming. Even for a country small in absolute size, certain developments, such as the near doubling of net bank credit to the Government in the last quarter of 1987 alone, revealed the extent of the disintegration of administrative controls. The speed and force of the reaction to the breakdown of the Fund-supported adjustment program also indicated that there may have been little or no faith in the program.

The objectives of the 1988 budget provided some initial hope that Somalia and the Fund were not speaking completely different languages, Mr. Enoch continued, but the vagueness of the underlying measures and deficiencies in supporting policies left considerable doubt about how far the authorities had reconsidered their attitudes, and whether their declared intentions had been largely presentational and aimed primarily at restoring aid inflows. The latest adjustments helped to alleviate those doubts, but it would be important to have a fuller picture of the recent measures, not least with respect to fiscal policy and the new foreign exchange allocation mechanism. He also would appreciate hearing from the staff about the new allocation mechanism. What was known suggested that the recent measures were limited, since, to his understanding, the devaluation of the Somali shilling from 100 to 180 per U.S. dollar represented no effective change for exporters, given that the parallel rate was close to So. Sh. 300 per dollar, and the previous right of exporters to retain 40 percent of export earnings had been rescinded. It was therefore difficult to be sure of the significance of the recent measures, although he did not doubt their domestic political significance or the difficulties that the authorities had confronted in implementing them. There was still an urgent need to reform policy on a broad front. As Mr. Al-Assaf had stressed, Somalia desperately needed a comprehensive and interlocking set of policy reforms. Partial adjustments had caused many of the difficulties in previous programs by overburdening individual instruments, such as the exchange rate.

It would also be important to see how the authorities would tackle the far-reaching structural reforms that were crucial to Somalia's future, Mr. Enoch observed. It was obvious, not least from the staff's bleak medium-term projections, that generous donor support over an extended period would be vital to the sustained recovery of the Somali economy. But donors would first need to be convinced that the direction of policy had been irreversibly changed, and the financing gaps projected over the medium term indicated that even the resumption of generous donor assistance would do little more than stabilize the situation at its present inadequate level. Indeed, the benefits that Somalia had been able to derive from some previous external assistance, particularly that which had financed the public investment program, appeared to have been questionable. Productive use of external assistance required policies encouraging an efficient allocation of resources.

The Fund's recent relationship with Somalia had been an uneasy one, Mr. Enoch commented. A start had been made in restoring mutual confidence, but much remained to be done before the Fund would again be able to provide effective assistance. An immediate obstacle was the arrears, which the projected accumulation of future obligations falling due threatened to propel to levels that would make an eventual solution extremely difficult. Until the arrears were cleared, the Fund's assistance would inevitably remain at a distance. The key to the elimination of arrears and consequent Fund assistance was the establishment of a convincing track record of adjustment, beginning with a shadow program. Chancellor Lawson had proposed at the recent Development Committee meeting that retrospective credit be given for such shadow programs under future arrangements under the structural adjustment facility and enhanced structural adjustment facility, and his chair intended to circulate a statement to Directors shortly setting out the idea in more detail. The objective of such retroactive credit would be to provide a strong incentive to countries in arrears to begin to establish a good track record. Such a track record would be particularly necessary in Somalia's case, given its prolonged use of the Fund's resources under five stand-by arrangements and an arrangement under the structural adjustment facility that had been met with a disappointing return. Further significant adjustment toward a more realistic exchange rate level and a decisive cut in the fiscal deficit would be an inevitable part of the adjustment process. Recognizing the difficulties of the past, the restoration of normal financial relations between Somalia and the Fund would also require a considerable effort by donors to follow through on their announced commitments in a timely manner, so that confidence in financing a sustained adjustment program could be provided both to Somalia and to the Fund. He had considerable sympathy for Mr. Finaish's concerns in that respect. If he were asked whether Somalia had jumped or was pushed out of the window last September, his answer would be "a bit of both."

He noted the severe weaknesses apparent in Somalia's institutional infrastructure, Mr. Enoch concluded. There was a clear and urgent need for technical assistance in Somalia, and if the authorities requested it, the Fund should provide it, given that the staff and the management were confident that the authorities would be receptive. Indeed, technical assistance might be an absolute prerequisite for any realistic adjustment program.

Mr. Rousset stated that he very much welcomed the measures that had been announced by the Somali authorities on June 20, 1988. The significant devaluation of the Somali shilling was a courageous decision indeed, and a good first step for which the authorities should be commended. Congratulations were probably also due to the Fund staff, whose missions had been instrumental in the authorities' decision to turn their economic policy around.

Given the tentative agreement between the authorities and the Fund on exchange rate policy and price control, the prospects for Somalia were probably somewhat more hopeful than the assessment in the staff appraisal, Mr. Rousset remarked. Nevertheless, the situation remained extremely difficult, and he concurred with Mr. Hogeweg about the damage done to the economy in 1987 as a result of inadequate policies. Efforts would have to be maintained and even intensified over a very long period of time in order to reverse the widening of imbalances which had occurred over the last year.

The measures described by Mr. Finaish represented a first step on the return to the adjustment path, Mr. Rousset concluded. The authorities should be encouraged to integrate their actions in the context of a comprehensive program which would be designed in close collaboration with the Fund. Full agreement on such a program would be an essential step toward securing the external resources that Somalia required both to finance its adjustment efforts and to normalize its relations with its creditors--with the Fund first of all. The small payment made by the Government to the Fund was welcome in that regard. It was to be hoped that the aims of a comprehensive program could be achieved in the coming months.

Mr. Morita stated that he welcomed the authorities' willingness to continue cooperating with the Fund, as well as the small payment recently made by Somalia to the Fund. He strongly hoped that the authorities would intensify their adjustment efforts, with close consultation with the Fund, and that Somalia would discharge its overdue financial obligations to the Fund.

The staff report presented a clear picture of Somalia's present economic situation, Mr. Morita observed. The unfortunate disruption of the Fund-supported program had resulted in the continuation of Somalia's domestic and external difficulties. Expansionary fiscal and monetary policies, coupled with unfavorable exogenous factors, had brought about rampant inflation. The balance of payments had deteriorated further, while external arrears had accumulated. The implications of the present policy were borne out in the gloomy medium-term scenario. In the face of that situation, the agreement reached by the staff with the authorities was a first step toward comprehensive adjustment, which was to be particularly welcomed. He also commended the authorities for having initiated a new exchange rate policy. However, much remained to be done before Somalia could attain credibility in the international community, and could mobilize the needed international assistance in adequate amounts. He concurred with the thrust of the staff recommendation in that respect, and encouraged the authorities to adopt a comprehensive adjustment program which would return them to a more promising adjustment path. As other speakers had noted, further efforts were required in the fiscal area, and emphasis should be placed upon making the exchange rate system more market oriented. He would urge the authorities to accelerate their momentum toward far-reaching adjustment, and he hoped that Somalia's arrears to the Fund would soon be eliminated.

The staff representative from the African Department stated that the staff recognized the considerable progress Somalia had made between 1980 and 1984. There had been a setback in the form of the ban on cattle exports in 1984, which had contributed to the downturn in Somalia's economic performance, but at the time the mission conducted the Article IV consultation with the Somali authorities, the staff had been struck by the large imbalances in the economy that had arisen in 1987. Government revenue in relation to ordinary expenditure, which was 90 percent in 1983, had fallen to 39 percent in 1987, for example; the overall fiscal deficit, which was 6.7 percent of GDP in 1983, had risen to 33 percent in 1987; credit to the private sector had more than doubled. The mission had not had the impression that the authorities would be willing to enter into meaningful discussions about a serious program of adjustment, and the staff report had been written in that context. The staff had been generally pleased by the frankness of its discussions with the authorities, although there had been no indication that the authorities would respond by inviting the staff to discuss some adjustment measures. The staff viewed the exchange rate adjustment that the authorities had undertaken as the very first step on a very long road toward adjustment. A comprehensive package to arrest the deterioration of the economy and to set the stage for much needed structural adjustment was essential.

The staff had already prepared a paper on the Fund's experience with the foreign exchange auction system, which would be issued shortly, the staff representative noted. A conclusion of that paper was that floating exchange rates under such an auction system could work reasonably well in developing countries experiencing large economic imbalances, but that the firm commitment of the countries to supporting the appropriate macroeconomic policies was necessary, and the programmed balance of payments support would need to be obtained on schedule. Therefore, the auction system could work well under certain circumstances, if supported by restrictive credit and budgetary policies.

As to whether the devaluation of June 20 had offset the appreciation of the real effective exchange rate that had taken place since September 1987, the staff representative went on, the devaluation had perhaps gone a long way in that direction, but the exchange rate still exceeded the

September level by about 27 percent. A full offset of that appreciation would imply an exchange rate of about So. Sh. 225-230 per U.S. dollar, and that was a level that the staff had discussed with the authorities. Nevertheless, the authorities' decision to move the rate from So. Sh. 100 to So. Sh. 180 per U.S. dollar was a courageous one for which the staff gave them credit. The staff would keep the exchange rate under close review, and the authorities had been made aware that further discrete adjustments in the rate would be required in the coming period.

If the average exchange rate for the period preceding September 1987 before the abandonment of the auction system were taken into account, it appeared that the exchange rate was moving in the right direction, the staff representative remarked. The staff had a clear understanding with the authorities that a new system that would eliminate the discretionary element in the allocation of foreign exchange would be put in place. The modalities of the foreign exchange allocation system were not yet in place, and the staff was not sure whether, under the new regime, foreign exchange for export receipts would be required to be fully surrendered to the authorities. The staff would discuss those matters with the Somali authorities.

A large subdivision of ordinary expenditure in the government budget had been identified as unclassified in the staff report, the staff representative observed, because Somalia's accounting system was such that the staff could not know where the expenditure had been made. However, during the last mission, the staff had pressed the authorities to provide data on the object of those expenditures. The staff thus discovered that out of the total of ordinary expenditure, interest on domestic and external debt absorbed about 20 percent; wages and salaries, about 9 percent, including for the military; defense and security, a little more than 20 percent. About 45-50 percent of total expenditure represented goods and services, and others. Undoubtedly, in formulating a program with the authorities the staff would like to know more about that part of the budget, and it was to be hoped that such information could be provided by the Somali accounting system.

On the question of whether the exchange rate adjustment that had taken place was dangerous in the absence of supporting demand-management measures, the staff representative continued, the staff's understanding was that since early 1988, when the new economic team had taken over, a restrictive demand-management policy had in fact been adopted. The 1988 budget was very restrictive, and the commercial banks had been required to recover domestic credit that had fallen due. The adequacy and success of the restrictive measures could not yet be judged, but the staff would be examining them in upcoming missions. The exchange rate adjustment had been necessary, as exports had stagnated. For example, exports of livestock had declined sharply, from a level of about $70 million to about $20 million. Some incentive to the exporters of livestock had therefore been clearly necessary. Given the demand management policies that the authorities had said they were pursuing, the exchange rate movement was appropriate, in the staff's view.

With respect to the quality of the data, the staff had impressed upon the authorities the need for massive technical assistance in several areas, the staff representative concluded. The staff had identified five areas where technical assistance was needed, namely, tax structure, tax administration, government accounting systems, expenditure control, and banking. The staff had understood that the authorities were preparing the terms for such technical assistance, which they had already requested from other countries and institutions. The staff would impress upon the authorities the fact that such assistance should be seen as an integral part of any Fund-supported program with Somalia. Unfortunately, the staff did not expect to see any results in that respect before late 1989.

Mr. Finaish stated that the Somali economy was at an important cross-road. The measures which the authorities had recently adopted provided a good opportunity for the Fund to take a leading role in helping the authorities make that turning point a positive one. As speakers had noted, issues yet remained to be discussed between the authorities and the staff, and he hoped that the staff mission that would be leaving for Somalia in the next few days would reach full agreement with the authorities on a policy plan for the period ahead. Once such an agreement was in place, the crucial task would be to secure external financial support to finance the adjustment program, and to help Somalia regularize its financial relations with the Fund. To be realistic, even in the initial phase, cash assistance would be needed, at least to meet essential import requirements and to avoid the further accumulation of arrears to the Fund.

Management and staff of the Fund would need to play an important role in that effort, Mr. Finaish continued. The authorities were aware that the Fund's ability to catalyze external support depended on the credibility of Somalia's adjustment effort, and the authorities had conveyed to him their willingness to do their part, as demonstrated by the actions they had already taken. Obviously, the Fund's own financial involvement would only be possible after Somalia had settled its arrears. The authorities were hopeful that their policy efforts would be met with adequate financial support in the months ahead, and that a full-fledged agreement with the Fund would soon be possible. Past experience had made it clear that in order to avoid interruptions in the adjustment process, external assistance had to be timely and in the needed form, however. That might require an extra effort on the part of creditors and donors as well as on the part of Somalia, but that effort was indispensable if the outlook for Somalia were to be improved.

The Chairman then made the following summing up:

> Executive Directors were in broad agreement with the staff appraisal, even though the staff report had been written before the advent of important new developments, which had made it necessary to introduce some nuances into that appraisal. Executive Directors expressed regret in particular that the Fund-supported program had been interrupted during the third quarter of 1987, and that policies had subsequently been

pursued--particularly with regard to price controls, fiscal and credit policies, as well as the exchange rate policy--that had caused a serious setback to the adjustment process. Directors pointed out that those policies were having serious effects on Somalia's economic prospects, which would take time to reverse. Directors expressed serious concern about the large and rapidly rising payments arrears and overdue financial obligations to the Fund, but noted and welcomed the small payment recently received by the Fund.

Directors urged the authorities to renew their commitment to adjustment and to revert to the adoption and implementation of a credible program over the medium term. In this connection, Directors welcomed the measures announced by the authorities on June 20, 1988. These included a 44.4 percent devaluation of the Somali shilling, and the pegging of the currency to a basket representing the currencies of Somalia's main trading partners. In addition, the price controls established earlier in 1988 were to be reviewed, and emphasis was to be placed on the removal of barriers to production and exports. A flexible exchange rate policy was to be pursued, with adjustments in the rate to reflect inflation differentials, and a new system of foreign exchange allocation was to be put in place. While the significance of those measures remained to be ascertained, including the remaining degree of overvaluation of the exchange rate, Directors expressed the hope that they would mark the resumption of a track record of adjustment which would enable Somalia to regularize its relations with its creditors, and eventually receive Fund support, once Somalia's overdue financial obligations to the Fund had been settled.

Directors emphasized that a comprehensive program would require the sustained--rather than piecemeal--pursuit of a realistic market-related and flexible exchange rate policy, measures to strengthen budgetary policy, including a substantial reduction in the overall fiscal deficit, a tight credit policy, and a resumption of free market pricing at all levels. The need to widen the tax base and to improve tax administration was stressed. Directors stressed also the need for extensive technical assistance to strengthen the data base and to enhance the prospect of successful implementation of such a program. Noting the Somali economy's weak resource base, vulnerability to external shocks, and dependence on foreign concessional assistance, Directors emphasized the importance of complementing the authorities' renewed resolve with timely aid flows in adequate amounts.

It is expected that the next Article IV consultation with Somalia will be held on the standard 12-month cycle. It is hoped that additional steps to regularize Somalia's financial relations with the Fund will be taken before the next consultation.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/88/98 (6/22/88) and EBM/88/99 (6/24/88).

3. RULES AND REGULATIONS - AMENDMENT OF RULE E-1

(a) The heading of the E-Rules shall be amended to read "Substitution of Securities for Currency."

(b) Rule E-1 shall be amended to read as follows (new text underscored):

> E-1. A member shall pay its currency subscription to the Fund at the designated depository. Each member is authorized to substitute, in accordance with Article III, Section 4, non-negotiable, non-interest bearing notes <u>or similar obligations</u> payable to the Fund on demand for that part of the currency holdings of the Fund in the General Resources Account which exceed 1/4 of 1 percent of the member's quota, and the depository shall hold such notes <u>or similar obligations</u> for the account of the Fund. Such notes <u>or similar obligations</u> shall not be accepted until the Fund is satisfied that they are in proper form and that their issue has been authorized. The balances held in the administrative accounts of the Fund shall not be considered as part of the currency holdings of the Fund for the application of this Rule.

Decision No. 8911-(88/99), adopted
June 23, 1988

4. *MAURITIUS - INTERIM ARTICLE IV CONSULTATION DISCUSSIONS - DECISION CONCLUDING 1988 ARTICLE XIV CONSULTATION*

1. The Fund takes this decision in concluding the 1988 Article XIV consultation with Mauritius, in the light of the 1988 staff report on the interim Article IV consultation discussions with Mauritius conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. With the exception of the restriction on nonbusiness travel allowance which is maintained in accordance with

Article XIV, Section 2, Mauritius maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions.

Decision No. 8912-(88/99), adopted
June 23, 1988

5. BARBADOS - TECHNICAL ASSISTANCE

In response to a request from the Barbados authorities for technical assistance in the fiscal area, the Executive Board approves the proposal set forth in EBD/88/169 (6/17/88).

Adopted June 22, 1988

6. TUNISIA - TECHNICAL ASSISTANCE

In response to a request from the Central Bank of Tunisia for technical assistance in the central banking area, the Executive Board approves the proposal set forth in EBD/88/171 (6/20/88).

Adopted June 23, 1988

7. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/88/150 (6/20/88) and EBAP/88/152 (6/22/88) and by an Advisor to Executive Director as set forth in EBAP/88/152 (6/22/88) is approved.

APPROVED: January 31, 1989

LEO VAN HOUTVEN
Secretary