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0404

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/12

3:00 p.m., January 29, 1988

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	J. A. K. Munthali, Temporary
	C. Enoch
Dai Q.	Jiang H.
C. H. Dallara	D. C. Templeman, Temporary
	J. Prader
A. Donoso	M. Hepp, Temporary
	A. M. Othman
	S. K. Fayyad, Temporary
G. Grosche	R. Wenzel, Temporary
	J. Reddy
	J. Hospedales
	J. R. N. Almeida, Temporary
	D. McCormack
Mawakani Samba	
Y. A. Nimatallah	I. A. Al-Assaf
G. Ortiz	
J. Ovi	M. Fogelholm
H. Ploix	D. Marcel
	G. Pineau, Temporary
G. A. Posthumus	G. P. J. Hogeweg
C. R. Rye	C.-Y. Lim
G. Salehkhou	O. Kabbaj
A. K. Sengupta	A. Vasudevan, Temporary
	S. Yoshikuni
	N. Kyriazidis
	S. Rebecchini, Temporary

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

Also Present

Asian Department: M. J. Fetherston, D. A. Scott, W. S. Tseng. European Department: R. K. Abrams, O. P. Brekk, N. L. Happe, A. Knöbl. Exchange and Trade Relations Department: H. B. Junz, S. Kanesa-Thasan, M. R. Kelly. Legal Department: F. P. Gianviti, General Counsel, W. E. Holder, Deputy General Counsel; R. H. Munzberg, J. M. Ogoola. Research Department: A. D. Crockett, Deputy Director; F. Larsen. Treasurer's Department: F. G. Laske, Treasurer; D. H. Brown, J. A. McLaughlin. Office of the Managing Director: R. Noë, Internal Auditor; C. P. McCoy. Advisors to Executive Directors: Khong K. N., K.-H. Kleine, A. Ouanes, M. Pétursson, I. Sliper, K. Yao, J. E. Zeas. Assistants to Executive Directors: R. Comotto, F. Di Mauro, M. A. Hammoudi, C. L. Haynes, G. K. Hodges, Hon C. W., S. King, K. Kpetigo, T. Morita, D. V. Nhien, C. Noriega, G. Schurr, C. C. A. van den Berg, E. L. Walker, R. Wenzel.

1. SPECIAL CONTINGENT ACCOUNT - ADDITIONS IN FY 1988 AND DISPOSITION OF AMOUNTS PLACED IN FY 1987 AND FY 1988; AND RETROACTIVE REDUCTION IN RATE OF CHARGE FOR FY 1988

The Executive Directors continued from the previous meeting their consideration of a staff paper on further considerations on additions to the Special Contingent Account (EBS/87/241, Sup. 1, 1/20/88).

The Acting Chairman indicated that a consensus seemed to have been developing around alternative (a) in the staff paper.

Mr. Sengupta recalled that in his original intervention he had supported alternative (b). He was prepared to accept alternative (a) since that had received the support of the staff. He would welcome future discussion of the full scope of the Special Contingent Account and the supplemental account. A decision should be taken at the current meeting to have all future additions to the Account be based on burden sharing.

Mr. Hospedales said that, while his chair had never been fully agreeable to the establishment of the Special Contingent Account and had proposed a modified version of alternative (b), he could support alternative (a) in the interest of reaching a consensus.

Mr. Enoch recalled that at the previous meeting his chair had stated its preference not to take a decision at the current meeting. If there was a consensus for alternative (a), he could go along with it as it stood, but he did not feel that that decision should set a precedent for some of the larger issues on burden sharing, contingency mechanisms, and the origin of contributions. Those were separate issues, which would be discussed later.

Mr. Grosche said that without a decision on the very nature of the Account, he was not in a position to agree to any other decision.

Mr. Kyriazidis remarked that, while he had been in favor of postponing the decision, if a consensus developed he would be prepared to accept the first part of alternative (a)--to transfer to the Special Contingent Account SDR 30.2 million from the original net target income. He was not in a position to support additional burden-shared contributions.

Mr. Munthali stated that, while his chair had also favored a postponement, in the interest of compromise he could go along with alternative (a) as it stood; the excess income should be used to retroactively reduce the rate of charge.

Mr. Mawakani said that he too had preferred to postpone any decision in order to be able to have all the relevant facts at hand, but given the consensus in the Board to take a decision at the current meeting, he would go along with alternative (a). At the same time, he agreed with the comment by Mr. Sengupta on the question of burden sharing.

Mr. Yoshikuni recalled that at the previous meeting he had indicated his preference to postpone the decision until the end of FY 1988. Even if he were to support alternative (a), he wished to postpone the decision on the disposition of excess income. However, if the majority supported alternative (a) as it was, perhaps he could do so.

Mr. Ovi remarked that he too had preferred to postpone the decision while arguing that the issue of burden sharing was important. He saw a consensus developing, but it was with considerable unease, and sharing all the reservations of Mr. Enoch, that he would support the adoption of alternative (a). Such a decision should not prejudge any future discussion on the Special Contingent Account or burden sharing. Before he could join the emerging consensus, he would like some information on why discussion of the use of enhanced structural adjustment facility resources for arrears problems had been postponed.

Mr. Kabbaj recalled that his chair had indicated a preference for alternative (b) at the previous meeting. Since the Board seemed to be moving toward a consensus on alternative (a), he could go along with it as it stood in the staff paper. His chair had indicated its unhappiness with the whole system for setting the rates of charge and remuneration and was looking forward to the review of burden sharing, which he hoped would be broad enough to encompass all the problems raised in the Board.

Mr. Fayyad indicated that he could support alternative (a) as it stood in the staff paper.

Mr. Ortiz recalled that at the previous meeting he had expressed his preference for alternative (b). He would have preferred to delve more deeply into the matters that had not been resolved, but perhaps that was not realistic. In adopting alternative (a), Directors would become involved in something without fully understanding all the potential implications. As long as that was understood, and it was agreed to make any further additions to the Account on the basis of the principles of burden sharing, he was also prepared to go along with the consensus.

Mr. Dallara said that he was prepared to support the gradually emerging consensus for alternative (a). He was also prepared to find some way to take account of Mr. Grosche's concern.

Mr. Donoso indicated that he, too, could support the view of the majority.

The Acting Chairman observed that there was sufficient consensus to support a decision along the lines of alternative (a).

The staff representative from the Legal Department suggested that on the basis of the discussion, the decision could be drafted along the following lines:

1. An amount equivalent to 2 1/2 percent of the Fund's reserves at the beginning of FY 1988 already provided for in accordance with Section II.1 of Decision No. 8348-(86/122), as amended, shall be placed to the Special Contingent Account at the end of FY 1988.

2. An additional amount equivalent to 2 1/2 percent of the Fund's reserves at the beginning of FY 1988 shall be raised in accordance with Section II.2 and Section V.1 and 2(a) of Decision No. 8348-(86/122), adopted July 25, 1986, as amended, as follows:

(i) effective February 1, 1988 the rate of charge referred to in Rule I-6(4), shall be 6.15 percent;

(ii) the rate of remuneration shall be adjusted for the period from February 1 to April 30, 1988 in order to generate an amount of net income equal to the amount generated under (i) subject to the limitation in Section V.2(c) of Decision No. 8348-(86/122), adopted July 25, 1986, as amended.

That additional amount shall also be placed to the Special Contingent Account at the end of FY 1988.

3. If the net income for FY 1988 exceeds 10 percent of the Fund's reserves at the beginning of FY 1988, the excess amount shall be used to reduce the rate of charge retroactively for FY 1988.

4. The amounts placed to the Special Contingent Account, including the amount placed to it in FY 1987, shall be distributed when there are no outstanding overdue charges and repurchases, or at such earlier time as the Fund may decide, in accordance with subparagraphs (a), (b), and (c) below:

(a) distributions of the amounts placed to the Special Contingent Account at the end of FY 1988 shall be made in proportion to the amounts that have been paid, or have not been received, by each member in FY 1988 as a result of adjustments made under paragraphs 1 and 2 above.

(b) the amount placed to the Special Contingent Account in FY 1987 shall be distributed to members that have paid charges referred to in Rule I-6(4) in FY 1987, in proportion to the amounts that have been paid;

(c) any distribution shall be made in proportion to the total amount to be distributed to each member under (a) and (b) cumulatively.

5. If any loss is charged against the Account, it shall be recorded in accordance with the principle of proportionality set forth in paragraph 4(c).

The first paragraph of the draft decision referred to an amount equivalent to 2.5 percent of the Fund's resources at the beginning of FY 1988 that was already provided for under Section II(1) of the present decision on burden sharing, which stated that that amount should be placed to the Special Contingent Account at the end of FY 1988, the staff representative explained.

The second paragraph of the draft decision provided that an additional amount equivalent to 2.5 percent of reserves at the beginning of FY 1988 be raised in accordance with Section II(2) and Section V(1) and 2(a) of the burdent sharing decision, the staff representative said, thus resulting in an adjustment of the rate of charge referred to in Rule I 6(4) to 6.15 percent and a corresponding adjustment to the rate of remuneration from the period from February 1 through April 30, 1988 to raise an equal amount subject to the limitations of the burden sharing decision. That additional 2.5 percent would also be placed to the Special Contingent Account at the end of FY 1988.

According to paragraph 3 of the draft decision, if net income for FY 1988 exceeded 10 percent of reserves at the beginning of FY 1988, then the excess amount should be used to retroactively reduce the rate of charge for FY 1988, the staff representative went on.

Paragraph 4 of the draft decision provided that the amount placed to the Special Contingent Account in FY 1987 would be distributed to members that had paid charges in FY 1987, the staff representative indicated, while amounts placed in FY 1988 would be distributed to members that had either paid charges or received reduced remuneration in FY 1988 in proportion to the amounts that had been paid, or had not been received, by each member as a result of the adjustments made under the paragraphs 1 and 2 of the draft decision. Thereby, the initial additional 2.5 percent of reserves became refundable. The last paragraph of the decision dealt with the issue of charging losses in accordance with the principle of proportionality.

On the timing of the dissolution of the Account, a combination of a fixed event--when there were no outstanding overdue charges and repurchases--and a judgmental approach--at such earlier date as the Fund might decide--would determine when the amount could be redistributed, the staff representative from the Legal Department concluded. Such a finding by the Board at an earlier date required a majority of the votes cast.

Mr. Nimatallah indicated that he could go along with the draft decision.

Mr. Grosche said that since the draft decision did not take into account his reservations, he would like to record his opposition to it.

Mr. Ovi noted that no mention had previously been made that net income in excess of 10 percent of reserves would be refunded. Also, future discussion on the Account would be pre-empted by including such a point in the decision. Those two issues ought to be treated separately.

The Treasurer noted that paragraph 3 of the draft decision was a reflection of the penultimate sentence in alternative (a), which read: "It would also be agreed that income in excess of the revised target amount of SDR 121 million would be used for a retroactive reduction of the rate of charge." Footnote 2 on that page set out the mechanics involved.

Mr. Dallara asked the staff to indicate how often it expected the Account to be reviewed. It seemed that the substance of paragraph 3 of the draft decision was a necessary part of the consensus at hand, but it could perhaps be made a separate decision.

The staff representative from the Legal Department indicated that such a separation would be possible. The two decisions could be taken at the current meeting, but given different decision numbers. The same majority--70 percent--would be required for both parts.

Mr. Kabbaj indicated that he considered the two parts to the decision to be interrelated.

Mr. Enoch stated that he preferred to have paragraph 3 separated into another decision. In addition, the draft decision should be entitled "Additions to the Special Contingent Account for FY 1988" in order to make it clear that the decision referred to only one addition and did not preclude further discussion on the subject.

Mr. Dallara said that the decision on a retroactive reduction of the rate of charge should be separate from the decision on the Special Contingent Account, since they were related but independent matters.

The Treasurer indicated that the staff had not yet given close attention to the question of reviews of the Special Contingent Account. That question involved two aspects: first, determination of additions to the Account, and, second, reductions to or the dissolution of the Account. In either case, the Executive Board would have to come to a judgment. The issue of additions to the Account would normally be considered in the context of the annual review of the Fund's income position and the relevant developments projected for the coming year. The dissolution of the Account might be considered, when appropriate, in the same context or on the occasion of a semiannual review of overdue obligations.

Mr. Yoshikuni said that he agreed with Mr. Enoch and Mr. Dallara that paragraph 3 should be a separate decision.

Mrs. Ploix considered that any additions in excess of the reserve target should be financed exclusively by the creditors.

After a further brief discussion, the staff representative from the Legal Department explained that the decision on retroactive reduction of the rate of charge was part of the determination of net income and would reduce the net income. Only after the determination of the net income would the decision on additions to reserves be taken. The decision on the retroactive reduction of the rate of charge, if taken by a 70 percent majority at the present meeting, could not be changed later.

There was a linkage between the Special Contingent Account and arrears in three ways, the staff representative from the Legal Department explained: first, through the original decision on the Special Contingent Account, which had been taken in view of existing overdue obligations; second, through the decision on burden sharing, which also referred to overdue obligations; and third, in the current decision on distribution of amounts in the Account, which referred to outstanding overdue charges and repurchases. In addition, a judgmental element, to be exercised by the Board, was included.

The Acting Chairman suggested that more general language could be brought into the original Special Contingent Account decision, which began "In view of the existing overdue obligations...." A more general statement might meet Mr. Grosche's concern and enable him to join the consensus.

Mr. Nimatallah proposed that the original decision creating the Special Contingent Account be amended to read: "In light of the development of some adverse circumstances, including the overdue payments arrears...." According to the draft decision under discussion, the need for the Account could be decided on by the Board, or could be left to the discretion of management, instead of stating specifically that "amounts shall be distributed when the need for such amounts disappeared."

The Treasurer commented that the text could read: "In view of the continued uncertainties in the international financial environment to which the Fund is exposed, including those evidenced by the level and duration of overdue obligations, the Fund establishes a Special Contingent Account."

Mr. Sengupta said that he preferred the original wording--"in view of the existing overdue obligations"--to the new, including "level and duration of overdue obligations."

Mr. Dallara remarked that, first, it should be made clear that the original decision was referring to overdue obligations to the Fund, and, second, those overdue obligations could not be considered to be uncertainties in the international financial environment.

The staff representative from the Legal Department said that the reference in the original decision establishing the Account to dissolving the Account when it was no longer needed referred back to overdue obligations.

Mr. Sengupta considered that the draft decision could read: "At the end of FY 1988, the Special Contingent Account will be merged with the supplemental income account, with any addition above 5 percent of reserves to be added to the merged account on the basis of burden sharing."

The Acting Chairman observed that the Board had achieved a relatively fragile consensus, and that perhaps that consensus should be taken, without ruling out the possibility of holding a more fundamental discussion at which the concerns of Mr. Grosche and other Directors could be accommodated.

Mr. Grosche said that his primary concern was the confirmation of the Special Contingent Account's legitimacy. If a decision were taken at the current meeting to dissolve the Account or merge it with a new account of another name--for example, "supplemental income account" was acceptable--he could support the rest of the draft decision. However, the overly precise mention of the arrears problem also gave him difficulty. He approved of Mr. Sengupta's suggestion that an account be developed that was related to reserves but was funded differently and could be refunded.

Mr. Dallara said that he had fundamental problems with Mr. Sengupta's suggestion. He had hoped that the staff's formulation would be satisfactory to Mr. Grosche because that solution had gone so far as to amend the initial decision. If that was not sufficient for Mr. Grosche, a more fundamental reorientation of the decision's thrust, along the lines of Mr. Sengupta's suggestion would cause major problems for his chair.

Mrs. Ploix commented that she regretted Mr. Dallara's position because she welcomed Mr. Sengupta's formulation, which encompassed what many Directors wished to accomplish at the current meeting.

Mr. Hogeweg said that, in contrast to Mr. Grosche, he was concerned about loosening the link between the Account and arrears. That would make the original Special Contingent Account decision much more general, and he hesitated to make such a fundamental amendment. Even the suggestion by the staff, which introduced the general financial environment, gave him some difficulty.

Mr. Enoch stated that he supported Mr. Dallara and had gone along with the draft decision on the grounds that it did not prejudge the outcome with respect to some of the more fundamental issues concerning the Special Contingent Account. He was reluctant to approve a rewording of the initial decision, particularly if it meant losing the support of Mr. Hogeweg.

Mr. Rye said that he agreed with Mr. Hogeweg that discussion of more fundamental changes to the Special Contingent Account should be deferred to another occasion.

The Acting Chairman said that he wished to assure Mr. Ovi that any decision taken at the current meeting would not affect existing understandings of the nature of the enhanced structural adjustment facility. In particular, funds allocated through that facility would not be used to clear arrears to the Fund.

Mr. Ovi said that, given the clarification, he could join the consensus at hand.

The Acting Chairman made the following concluding remarks:

> While I will not attempt to summarize the varied views expressed by Directors today on additions to the Special Contingent Account, I would stress that the decisions now reached by a fragile consensus will not prejudge in any way any future decisions on the Special Contingent Account or on burden sharing. Thus, in order to meet the concerns of Directors as expressed at this and previous Board meetings, today's decisions do not preclude a more fundamental discussion on the Account, which would take place in the context of our forthcoming review of the decision on burden sharing.
>
> Some Directors made reference to the enhanced structural adjustment facility in the context of the arrears problem. The Managing Director has stated several times that members in arrears to the Fund would not have access to the enhanced structural adjustment facility, just as they do not currently have access to the structural adjustment facility (EBM/87/171, 12/15/87), or the facilities in the Fund's General Resources Account. Thus, the existing arrears policy is not changed or modified in the context of the enhanced structural adjustment facility. At the heart of dealing with those cases in which arrears exist are the elements of a strong adjustment program which will assist in attracting external resources to help the country clear its arrears. The Fund could then grant access to its facilities as appropriate, including, of course, the enhanced structural adjustment facility when it becomes operational.

The Executive Directors then took the following decisions:

1. Special Contingent Account - Additions in FY 1988 and Disposition of Amounts Placed in FY 1987 and FY 1988

1. An amount equivalent to 2 1/2 percent of the Fund's reserves at the beginning of financial year 1988 already provided

for in accordance with Section II.1 of Decision No. 8348-(86/122), adopted July 25, 1986, as amended, shall be placed to the Special Contingent Account at the end of financial year 1988.

2. An additional amount equivalent to 2 1/2 percent of the Fund's reserves at the beginning of financial year 1988 shall be raised in accordance with Section II.2 and Section V.1 and 2(a) of Decision No. 8348-(86/122), as amended, as follows:

(a) effective February 1, 1988 the rate of charge referred to in Rule I-6(4) shall be 6.15 percent;

(b) the rate of remuneration shall be adjusted for the period from February 1 through April 30, 1988 in order to generate an amount of net income equal to the amount generated under (a) subject to the limitation in Section V.2(c) of Decision No. 8348-(86/122), as amended.

That additional amount shall also be placed to the Special Contingent Account at the end of financial year 1988.

3. The amounts placed to the Special Contingent Account, including the amount placed to it in financial year 1987, shall be distributed when there are no outstanding overdue charges and repurchases, or at such earlier time as the Fund may decide, in accordance with subparagraphs (a), (b), and (c) below:

(a) distributions of the amounts placed to the Special Contingent Account at the end of financial year 1988 shall be made in proportion to the amounts that have been paid, or have not been received, by each member in financial year 1988 as a result of adjustments made under paragraphs 1 and 2 above;

(b) the amount placed to the Special Contingent Account in financial year 1987 shall be distributed to members that have paid charges referred to in Rule I-6(4) in financial year 1987, in proportion to the amounts that have been paid;

(c) any distribution shall be made in proportion to the total amount to be distributed to each member under (a) and (b) cumulatively.

4. If any loss is charged against the Account, it shall be recorded in accordance with the principle of proportionality set forth in paragraph 3(c).

Decision No. 8780-(88/12), adopted
January 29, 1988

2. Retroactive Reduction of Rate of Charge for FY 1988

If the net income for financial year 1988 exceeds 10 percent of the Fund's reserves at the beginning of financial year 1988, the excess amount shall be used to reduce the rate of charge retroactively for financial year 1988.

Decision No. 8781-(88/12), adopted
January 29, 1988

2. NEWLY INDUSTRIALIZING ECONOMIES (NIEs) - REQUEST FOR STUDY

Mr. Posthumus said that he wished to make a suggestion based on the summing up of the discussion at EBM/88/6 (1/13/88) on the preliminary prospects for the world economic outlook. At that meeting, and in other forums, there had been increasing interest in the situation and policies of the newly industrializing countries in Asia. Their policies were also being seen in the context of a more global coordination of policies and required adjustment processes. He proposed that the Board request the staff to prepare a paper containing information on and an appraisal of those countries' situations and policies before the next world economic outlook documents were distributed to the Board. The Fund could manage such an assignment better than any other institution, and such a document could assist Executive Directors and their authorities in forming opinions concerning the newly industrializing countries. There were substantial differences between each of the four economies concerned, both in financial and economic respects and in their relationship with the Fund.

Mr. Lim commented that if Mr. Posthumus's proposal for a staff paper was intended to initiate special surveillance, his Korean authorities would strongly object. Korea had had supplemental surveillance during 1987, and since then there had been no other case of special surveillance. In the summing up of the discussion at EBM/88/6, the Chairman had said that one way of sending strong signals to the G-7 countries "could be to conduct a 'Special G-7 Updating' before each world economic outlook.... This should not take away from our attention to other important country groupings, such as the surplus countries in Europe, which as a group has a significant impact on the global imbalances of the world economy, the newly industrializing countries, the heavily indebted countries...." In that context, he could not understand why the Asian newly industrializing countries should be particularly selected for a special staff report. Also, Mr. Posthumus's proposal could be justified only if it were limited to Taiwan and Hong Kong, which were not members of the Fund, since papers containing information on those countries had never been produced for the Executive Board. Furthermore, the 1988 Article IV consultation with Korea would be held in March, with a staff report being issued in April.

Mr. Dallara stated that he supported Mr. Posthumus's suggestion, which he believed was a natural outgrowth of the summing up of the discussion at EBM/88/6; the staff paper need not involve any particularly

unique effort, nor should it be considered as special surveillance. The fact was that the evolution of the newly industrializing economies' external positions was an important aspect of global payments imbalances. Accordingly, considered analysis of their positions seemed to be particularly appropriate. In addition, the staff report on the 1988 Article IV consultation with Korea would not be available to the Board in time to provide background information for the upcoming world economic outlook discussions.

Mr. Posthumus said that while there had been a special consultation with Korea in 1987, he was not proposing a consultation; he simply felt that full information on the economies in question would facilitate discussion of that group. He was merely asking for a staff report, without attendant Board discussion.

Mr. Nimatallah noted that when the oil producing countries had had a significant impact on the rest of the world--owing to their size of trade, external balance, and surplus--the Fund had grouped those countries together. It seemed appropriate to assess whether the newly industrializing countries had a large enough impact on the rest of the world to deserve to be viewed as a separate group. However, if Mr. Posthumus had only the surplus newly industrializing economies in mind, further explanation would be needed on why those particular countries had to be singled out.

Mr. Posthumus said that discussions on those specific countries were going on, and it would be useful to have information on them; he was not singling them out.

Mr. Prader agreed that any study should be of the newly industrializing countries in general, and not specifically the surplus countries. However, was the situation of those countries not already contained in the World Economic Outlook? While additional information was always justified, a request from the Board for information in the context of the world economic outlook discussions did carry political implications, and, therefore, he did not consider it necessary to issue additional documents.

Mr. Yoshikuni said that, while he sympathized with the concerns of Mr. Posthumus and Mr. Dallara, there was no urgent need for a special review at the present time; the World Economic Outlook had references to the newly industrializing economies, and perhaps Mr. Posthumus's proposal could be considered after the next world economic outlook discussions.

Mr. Dai noted that the term "NICs," or newly industrializing countries, generally referred to the four "small dragons" in Asia--Korea, Taiwan, Hong Kong, and Singapore. China's position was clearly that Taiwan was part of China and not an independent country. It was preferable, as had been done in the recent communiqué issued by the President of the United States and the Prime Minister of Japan, to use the term "newly industrializing economies." The terms should not be confused; the difference was a matter of political implication.

Mr. Ovi said that while he agreed with Mr. Posthumus, he understood Mr. Lim's concerns, and care should be taken to ensure that the special consultation procedure used in 1987 with Korea was not used vis-à-vis smaller countries alone. However, in global economic discussions, reference was constantly being made to the newly industrialized economies, and further information on them was desperately needed.

Mr. Lim said that after hearing Directors' comments, he felt it might be reasonable to accommodate Mr. Posthumus's request in the World Economic Outlook. Singling out of the newly industrializing economies for a separate paper could have the wrong implication for his authorities and the citizens of their country. It might be felt that the Fund was treating Korea unfairly, which could damage that country's relationship with the Fund for coming years.

Mrs. Hepp stated that she supported Mr. Lim's objection to issuing a special study on the newly industrializing economies separate from the World Economic Outlook.

Mr. Enoch said that he supported Mr. Posthumus's request while agreeing with the comments by Mr. Ovi. He understood Mr. Lim's concern about Korea being singled out, but the newly industrializing economies were a major part of the world economy and had a significant impact on a number of global issues. The Board tended to look closely at the major countries and the debtor countries but generally had less information on the small surplus economies.

Mr. Dallara commented that he agreed with Mr. Dai that care should be taken to refer to Taiwan as an economy, and not a country. Perhaps one way to compromise between the positions of Mr. Lim and Mr. Posthumus would be to have the study on the newly industrializing economies be a supplement to, but part of the overall documentation for, the upcoming world economic outlook discussions.

Mr. McCormack said that he shared the desire of Directors to have more information about the newly industrializing economies, and agreed that more should be done in the context of the world economic outlook discussions; Mr. Dallara's suggestion was an appropriate one. He did have some reservations about adding to the work of the world economic outlook review on an ad hoc basis, but additional information should be made available within that context.

Mr. Posthumus remarked that he had assumed that work on the newly industrializing economies would be necessary in the framework of preparations for the world economic outlook discussions, since their situation was a pertinent issue; his proposal had been that the information simply be made available earlier.

Mr. Rebecchini said that he supported Mr. Posthumus's initiative, while reassuring Mr. Lim that no symbolic meaning should be attached to that support.

Mr. Salehkhou commented that the world economic outlook discussions used to be an evaluation of projections for the global economy, but had somehow changed in recent years, since the beginning of the debt crisis and the introduction of major imbalances in the global economy. For the past three or four years, the Board had regarded world economic outlook studies as a means of surveillance over the major industrial economies. It seemed that adding a special document that focused on two members as well as two nonmembers could be interpreted as inflicting additional surveillance on those economies.

Mr. Pineau said that he approved Mr. Posthumus' request. While his authorities were aware of the sensitivity of the issue, they felt that it was in the best interest of the newly industrializing economies that more information be made available on their economic developments; the Fund was the most suitable institution to carry out such fact-finding work.

Mr. Almeida said that he could support additional statistical tables being issued in the World Economic Outlook. It would not be appropriate to issue a separate document.

Mr. Vasudevan inquired as to whether or not there was already a separate section in the World Economic Outlook on the newly industrializing economies.

The Deputy Director of the Research Department said that there was not formally a separate section on the newly industrializing economies, although they were referred to as a group whenever it seemed appropriate in the context of the analysis being undertaken.

Mr. Vasudevan said that while additional information on the newly industrializing economies might be appropriate in the context of the World Economic Outlook, it should not be issued as a supplement or as a separate document.

Mr. Nimatallah suggested that further analysis and information be made available within the World Economic Outlook on the newly industrializing economies in general. In that way, Korea would not be singled out, and the information that Mr. Posthumus had requested would be made available to Directors.

Mr. Posthumus said that he had simply wished to receive background information in the framework of the world economic outlook discussions. He did not wish the published World Economic Outlook document to be changed. His request for such background information was meant only to make information available to the Board.

Mr. Lim remarked that he appreciated that Mr. Posthumus's intention was not to cause difficulty for individual member countries. He could perhaps further discuss the matter with Mr. Posthumus on a bilateral basis.

Mr. Reddy noted that one of the countries in his constituency was categorized as a newly industrializing economy. He too was concerned about isolating such a small group of countries for separate treatment. While a focus in the regular World Economic Outlook on some of those countries would be acceptable, he did have strong objection to issuing a separate paper. It was true that some of the economies had been facing difficulties, but they were essentially of a bilateral nature and were not posing any systemic problems. Therefore, a separate study of that group of economies in the context of the world economic outlook exercises certainly was not warranted.

He could support Mr. Lim's proposal that bilateral discussions be held with Mr. Posthumus in an attempt to resolve the issue, Mr. Reddy concluded.

Mr. Templeman noted that there was a large current account surplus between the newly industrializing economies and various major industrial countries. The newly industrializing economies were very important players in the world balance of payments. While they were included in the World Economic Outlook under the heading of Asia, which as a whole had registered a large surplus, it was difficult to perceive the impact of those four economies in particular.

The Acting Chairman said that the subject of a study on the newly industrializing economies was rather complex to be discussed under other business. The world economic outlook exercise was well under way, and while the staff would certainly be touching on the issue, it would not be possible to accommodate a request for a special study now. Given that two of the economies were not members of the Fund, and extensive information could therefore not be obtained, perhaps the question of a special study should be left for later discussion. Bilateral discussion, as Mr. Posthumus and Mr. Lim had suggested, might also be useful.

Mr. Nimatallah agreed that the idea of grouping the newly industrializing economies should perhaps be discussed in a different context.

Mr. Posthumus noted that he had not suggested a special study or a different grouping. He had wanted the additional information to be made available in the framework of the world economic outlook preparations because the countries in question had a specific influence on the international adjustment process, which had been referred to in the latest mini-world economic outlook discussions. He was concerned that the economies were being discussed on the basis of insufficient information.

Mr. Templeman said that he too had not had in mind any recategorization of the newly industrializing economies as Mr. Nimatallah had suggested. Rather, he was interested in balance of payments adjustment information for those economies. A series of supplements on various topics had been issued at various times for the world economic outlook review, and it would be useful if they were distributed as they became ready, rather than sending them to Directors as one large package.

The Deputy Director of the Research Department said that the staff would be adding supplementary material to be placed in annexes to the main World Economic Outlook text. As far as the packaging of the documents was concerned, while it would not be practical to issue very short pieces on their own, he understood that it was inconvenient for Directors to absorb the whole package at once. The staff would make every attempt to release the papers in time for Directors to pursue their topics of interest.

The Acting Chairman commented that to the extent that examination of the impact of the newly industrializing economies on the world economy could be taken into account during more general work on the world economic outlook review, the staff should seek to do that. Some reflection would have to be given on the question of how to deal with the two important economies that were not members of the Fund. It was not clear how much information the staff could produce on the nonmember countries, since the Fund had very limited information other than that generally available to the outside public. The whole issue would have to be examined and discussed at a future date.

3. ICELAND - 1987 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1987 Article IV consultation with Iceland (SM/87/289, 12/11/87). They also had before them a background paper on recent economic developments in Iceland (SM/88/14, 1/15/88).

Mr. Ovi made the following statement:

> The staff report provides a clear and concise analysis of the current state of the Icelandic economy and presents, on the whole, a balanced view of economic developments in the period between the two most recent consultation discussions. My authorities extend their gratitude to the staff for their effort. There is little reason for me to provide much supplemental material. I will limit my comments to updating information on developments in 1987 and will touch briefly on structural reforms in the economy.
>
> Fiscal, monetary, wage, and price developments in 1987 were broadly in line with earlier forecasts, but the external balance proved to be considerably worse than expected. It is now estimated that the current account deficit for 1987 was 3.1 percent of GDP instead of the 1.2 percent deficit forecast in October. This is due to slightly lower export production and exports than previously envisaged, and an underestimate of the surge in merchandise imports. The impact of the real income gains on imports in 1987 was greater than had been expected.

In other respects, the external position is better than it has been for several years. The net external debt of the economy--public and private--as a percentage of GDP declined for the third consecutive year and is estimated at just below 38 percent at the end of 1987 compared with 52.5 percent at the end of 1985. The external debt service ratio has fallen from 24.3 percent of export revenue in 1984 to under 16 percent in 1987.

Tentative figures indicate that the Central Government's operational budget outcome in 1987 was broadly in line with expectations. The public borrowing requirement seems to have been slightly greater than projected, and central bank financing was of somewhat lesser importance than previously forecast, as other sources were tapped, particularly through the issuance of treasury bills. Moreover, planned domestic bond sales to the public were fully realized.

Monetary developments in 1987 were characterized by rapid credit expansion and rising interest rates. The 36 percent increase in total deposits shows that the positive development in recent years of real increases in total deposits continued in 1987. Credit, however, expanded even faster, at 46 percent. Higher interest rates, especially in the second half of the year, did not manage to reverse this development. The real interest rate on medium-term indexed bank loans rose from about 6 percent at the beginning of 1987 to 9.5 percent at the end of the year.

Prices, as measured by the cost of living index, rose by about 24.5 percent over the course of 1987 and wages increased by about 37 percent, indicating a surge in real wages with a slight real wage overhang being carried into 1988.

As described in the staff report, the Government has followed a policy of maintaining a stable nominal exchange rate. The resulting appreciation of the real exchange rate of the krona has squeezed the profitability of export and import competing industries. This, together with the fall in the value of the U.S. dollar, has put pressure on the exchange rate policy.

Little can be said at this stage about the economic prospects for 1988 beyond what is described in the staff report. As is mentioned in the report, economic growth will be much slower in 1988 and could even stagnate. It is necessary to reduce the size of the catch of some important fish species from last year's catch, and a considerable slowdown in the growth of domestic demand is expected. As far as the real economy is concerned, present indications are that both export production and exports overall will be better than envisaged in October. In light of the outcome of 1987 and the external prospects for 1988, it is evident that the authorities have to pursue a restrictive

policy. Wage negotiations are under way, and the Government's declared policy is that there is no room for general increases in real wages.

The Government has stated that its primary objective in the present circumstances will be to simultaneously facilitate an improvement in the competitive position of export industries and a viable income settlement in the private sector. The two cannot be separated.

The staff devotes one section of its report to structural reform in the economy. My authorities believe that the issue is of such importance that some elaboration of recent changes is warranted.

The fisheries quota system, which was first enacted in 1984, has been extended for another three years. The system's main objectives are to preserve and secure optimal utilization of the fish stocks and to increase efficiency in this important sector. The quota system does not include a provision for public selling or auction of quotas, but the transferability of quotas between individuals or firms remains open. The arrangement has contributed to more efficient operations of the fishing fleet and has led to a noticeable change in emphasis from quantity to quality of the catch. Another important step in increasing efficiency in the sector was the introduction in 1987 of auction markets for fresh fish.

In recent years the financial sector in Iceland has undergone a major transformation. Interest rates have been completely liberalized and automatic access by commercial banks to central bank money has been severely curtailed. Treasury bills were issued again in 1987 and marketed more aggressively than before. Rules on foreign borrowing, and purchase and financial leasing have all been liberalized and the economy has been opened up in this respect. In October 1987, the Government announced that domestic residents would be allowed to purchase foreign securities. A bond market has also developed rapidly, and a securities exchange commenced operations in 1986. The effects of these measures are manifold. Real interest rates have risen sharply, requiring more careful investment decision making, and financial savings have risen strongly.

Liberalization of the financial market has occurred only in the past few years. As stated in the staff report, the market is not yet highly sophisticated, but the importance of the changes is not questioned, and the Government will promote further development in this area.

A major overhaul and streamlining of the tax system was enacted in connection with the fiscal budget for 1988. The state income tax code for individuals has been greatly simplified, and a pay as you earn scheme for the collection of the tax introduced. The income tax rates have been reduced from three rates to one rate of 28.5 percent, and the number of deductions and allowances has been drastically curtailed. A local income tax of 6.7 percent is also collected under the pay as you earn scheme. A revision of the corporate income tax and other business taxation is on the Government's agenda.

The sales tax base has been broadened to include virtually all goods and services. The broadening of the tax base serves two purposes. First, it simplifies collection and serves to curb tax evasion. Second, it is a preparatory step for the introduction of a comprehensive value-added tax set for the beginning of 1989 at a flat rate of 22 percent. The Government decided to keep the sales tax rate at 25 percent in 1988, even though the broader tax base could have made a rate reduction possible. Instead, it used the increased revenue to facilitate a sweeping reform of tariffs and excise taxes.

The tariff system has been simplified. The maximum rate has been reduced from 80 percent to 30 percent, and the rate structure now consists of just 7 rates instead of about 40. At the same time, 6 excise taxes, with a maximum rate of 30 percent, were replaced by 1 excise tax of 14 percent on a relatively narrow base. In addition, a new tariff code based on the realities of modern living was introduced. As a result, many daily consumer goods are no longer treated as luxury goods.

The Icelandic economy is in a transition period. A four-year period of very rapid economic growth is coming to an end. My authorities recognize this, and they will not hesitate to act to ensure stability in the economy and a viable external position. At the same time, they will continue on the road of structural reform and liberalization of the economy in the belief that an economy in which market forces play a major role will be better able to adjust to ever-changing external and internal conditions.

Mrs. Hepp made the following statement:

The performance of the Icelandic economy in 1987 was mixed. On the one hand, the path of rapid growth achieved in previous years was continued. In fact, estimated GDP growth was 6.3 percent, stimulated by record fish catches and high fish export prices, fishing being one of the country's main economic activities. This result was achieved at the time of a tightening of labor market conditions, with the unemployment rate at 0.5 percent--in line with the primary objective of full employment--with

vacancies representing 4 percent of the labor force and wages rising by 39 percent in 1987--an increase of 18 percent in real terms.

On the other hand, the rate of inflation increased during the year, which added to the maintenance of a stable effective exchange rate, resulting in a strong real appreciation of the krona. Despite the improvement in the terms of trade, the external balance deteriorated sharply, resulting in a current account deficit of 3.1 percent of GDP.

However, in analyzing Iceland's economic prospects for the short and medium term, there are two issues that are cause for concern. The first is evidence of some overheating in the economy. While the new authorities introduced some fiscal and monetary measures in July and October 1987 to cool down the economy, the persistence of those conditions calls for the adoption of additional measures.

The second issue is the limited capacity for continued expansion of the fishing sector without putting the fish stock at risk. The present cycle of growth based on the expansion of the fishing sector might be nearing an end.

With this picture in mind, we cannot but agree with the staff appraisal, and with the not very optimistic prospects for 1988. We concur that there is little benefit from adjusting the exchange rate in the present circumstances of an overheated economy. Nevertheless, the sharp appreciation of the exchange rate mentioned before and the revised estimate for the current account deficit in 1987 seem to suggest that a review of the exchange rate policy might be needed if a tendency toward deterioration of the external balance becomes apparent; this might be necessary sooner or later to restore competitiveness and minimize the vulnerability of the balance of payments.

Therefore, if the exchange rate policy is to be maintained in the short run, with the aim of holding down inflation and reducing pressures for further wage increases, domestic demand needs to be strongly restrained. Tighter demand management should include not only a tighter monetary policy, but also a combination of fiscal and monetary measures, so as to achieve the needed adjustment.

We have noted with interest the description of structural reforms in Mr. Ovi's statement and in the staff papers. We commend the authorities for the important structural measures that continue to be taken in the different policy areas. Particularly welcome are the price deregulation, the review of policies for fisheries and agriculture, the financial reform, and the reorganization of the tax system.

Mr. Templeman made the following statement:

Some very positive developments have occurred in the Icelandic economy over the last few years: real growth of GDP has averaged nearly 5 percent over the past four years; the rate of inflation has come down somewhat; virtually full employment has been achieved; the current account of the balance of payments has strengthened considerably since 1984/85; the gross public sector borrowing requirement has been cut; and some important structural reforms, notably tax reform and financial market reforms, are under way. While recent external developments have been favorable, especially the size of the fish catch and the terms of trade, there is no doubt that prudent economic policy has also been an important factor. Nonetheless, there are signs of overheating in the economy and uncertainties about the external economic environment, which raise some questions about the durability of these achievements if some economic policies are not strengthened.

Over the medium term, sustainable and more diversified economic growth will depend importantly on: an improvement in the savings and investment pattern to augment supply; containment of domestic demand through prudent monetary and fiscal policies; and a realistic exchange rate policy to help to allocate resources appropriately between the domestic and foreign markets.

Despite the good overall economic growth rate in recent years, there are some reasons to be concerned about the composition of growth. For example, overall growth has been quite dependent on the rapid growth of private consumption in response to surprisingly high rates of real earnings. Growth of the volume of exports of goods and services has been tapering off and could turn negative this year. Also, the rate of growth of imports of goods and services was exceptionally high in 1987 and is likely to remain high in 1988. In addition, the pattern of domestic savings is cause for some concern. While the private savings ratio rose to 16.3 percent last year from a low of 15.3 percent in 1985, the public savings ratio last year was only one half the average ratio of 7.6 percent over the five-year period 1980-84. These figures support the case for a more rapid reduction in the fiscal deficit and highlight the importance of the tax and financial market reforms under way, in terms of their effects on incentives to save and on the efficiency of intermediation.

Admittedly, the fiscal deficit has been substantially reduced from the peak gross public sector borrowing requirement of 6.8 percent in 1985, to an expected 2.6 percent for 1988. Corrective fiscal measures last July and October, as well as measures in the 1988 budget, have helped to contain the deficit and are aimed at achieving balance in the operational deficit of

the Central Government this year. Nonetheless, it does appear that an actual operational surplus may be needed, along with some further improvement in private savings, if the overall level of domestic savings needed to sustain growth is to be achieved. In that connection, we commend the authorities for the ongoing comprehensive tax reforms. It is particularly important that the impact of these reforms on savings be kept firmly in mind.

In the past, some fiscal concessions have been agreed with labor unions as a means of helping to contain wages. There is now clearly a need to contain the rise in real earnings, but no room for fiscal concessions. The goal of no increase in real wages in 1988 makes sense, following annual increases of real earnings in the range of 7 1/2 percent to 18 percent over the past three years, but we wonder about the realism of such an ambitious target and whether anything can be said about 1988 wage prospects beyond the brief reference in Mr. Ovi's statement.

In the monetary area, there has been a very substantial rise in real interest rates since the freeing up of rates. This is particularly apparent between late November of 1987 and late November of 1986, when real rates on indexed loans were 9.5 percent. At the same time, indexed deposits were yielding much lower positive real rates. This pattern raises questions about whether such high lending rates will tend to hurt business investment, why high rates have not reduced loan demand more, and why the spread between deposit and lending rates is so high. We also share the concern expressed by the staff about the limits placed on the exercise of monetary control by the widespread indexation of the monetary aggregates.

As to the external sector, the reduction in the current account deficit has also contributed to lower foreign debt and debt service ratios, with the debt ratio dropping substantially from 61 percent in 1984 to about 37 percent last year and the debt service ratio falling from about 24 percent to about 16 percent. The rapid growth of GDP and exports in the denominators of those ratios has been very helpful. Also, the appreciation of the exchange rate has helped to limit the size of the numerator in the debt ratio. However, there are reasons to wonder whether this pattern will continue, in light of the overheating of the economy, indications that fish exports have topped out, the stagnation in nonfish exports, and the possibility that the exchange rate will eventually need to be depreciated. The upward revision of the 1987 current account deficit to 3.1 percent of GDP and the staff estimate that the deficit this year could be on the order of 4.5 percent are further cause for some concern about whether domestic demand is being adequately restrained and whether Iceland's competitive position has been eroded. For example, the chart on page 12a of the staff report

indicates that the cumulative real effective appreciation of the króna amounted to about 18 percent from mid-1986 until the end of 1987. We would welcome any update on exchange rate movements since then.

The staff also presents four very interesting medium-term scenarios based on either high or low fish exports and on the extent of adjustment achieved in 1988. Of course, these are imprecise estimates, but the message seems clear. At least in the less favorable scenarios, some combination of additional restraint on domestic demand and exchange rate depreciation may prove necessary in coming years in order to contain the debt burden.

In conclusion, some warning signs are clear. The authorities seem to be quite well aware of the dangers. We hope that they will respond promptly, with strong corrective policies should that prove necessary. We would encourage the staff to monitor the situation carefully in the coming year, with a view to determining whether there will be any need for the Board to examine this case before the end of the new 24-month cycle.

Mr. Hogeweg made the following statement:

The staff analysis clearly points to the overheating of the Icelandic economy. It seems that the volcanic character of the island is also visible in its economics. I understand that the authorities basically agree with the staff's diagnosis, but there are some differences as to the cure.

One of the appendices to the background paper notes the high social rate of discount in Iceland and the finding that economic policy in Iceland is being conducted with a relatively short time perspective. Maybe it is in this light that we should interpret the statement in the introduction to the staff report that the authorities' primary objective is the maintenance of full employment and that this policy is being vigorously pursued even at the expense of price stability and the balance of payments. This seems to have led to the number of vacancies far exceeding the number of unemployed, while the resulting real wage increases undermine competitiveness, with or without depreciation of the exchange rate. There is therefore little prospect that the economy will grow less dependent on the fishing sector, which could improve future economic performance.

Indeed, price stability seems to have a regrettably low priority. It is not even mentioned among the main objectives of monetary policy in recent years listed on page 9 of the report. Furthermore, I understand that inflation is so entrenched in Iceland that it has given rise to widespread indexation of

financial titles, which seriously hampers monetary policy. The recent introduction of exchange rate-linked bank deposits is a further step in the wrong direction. I would very much appreciate further information from the staff on the precise nature of these deposits.

We found striking similarities between the indexation experience of Iceland and Israel. Given the very limited power of monetary policy due to indexation, the Israeli Government, as long as the fundamental roots of the instability are not tackled, alternates between fighting inflation by fixing the exchange rate--thereby undermining competitiveness--and fighting the current account deficit by devaluations--thereby fueling inflation. Likewise, their experience with exchange rate-linked deposits in such an environment has been very negative. Such deposits add to indexation generally, and the instrument has proven to be an additional source of instability in the domestic financial market, since it gave rise to liquidity problems for banks whenever devaluations were expected. I strongly believe that indexation features among the structural problems of the Icelandic economy that should be tackled. Decisive demand management through fiscal and monetary restraint could remove the perceived need for indexation.

Another clear candidate for structural reform is the housing finance system. This cheap source of housing finance clearly distorts the allocation of resources, directs scarce domestic savings in a suboptimal direction, and undermines monetary policy.

I found the discussion between staff and authorities on exchange rate policy most interesting. The authorities seem to have good intentions, with the effective exchange rate being their last nominal anchor, letting go of which they feel would not solve anything. In this regard, I feel the authorities are entirely right. However, the staff has a point that there comes a time when the exchange rate becomes so overvalued that adjustment cannot be avoided. In these circumstances, it is better to adjust it willingly, but as part of a comprehensive policy package, than to let adjustment be forced by economic realities. I would stress the importance of strong accompanying measures in all other policy areas if the authorities decide on a depreciation. It seems that depreciation as a short-term measure to improve competitiveness of the nonfish traded goods sector would be counterproductive. There will have to be room for expansion of this sector to achieve the objective of improved competitiveness, and that room will not be there if the overheating of the economy is not tackled effectively. Failing measures of that kind, the economy may indeed experience volcanic conditions.

Mr. Enoch said while many other, generally developing, countries were currently suffering from the downside risks of dependence on one commodity, Iceland had, since 1984, been fortunate enough to have experienced the upside gains. Larger fish catches and export prices, combined with lower oil prices, had provided a significant boost to the economy, which had showed enviable rates of growth over the past few years. Unfortunately, those developments might have disguised many of Iceland's fundamental economic weaknesses and delayed desirable corrections.

At the risk of oversimplification, it appeared that Iceland could be in danger of slipping into a vicious circle, Mr. Enoch went on. The primary objective of low unemployment had encouraged rapid growth in real wages, in reaction to which the authorities had tried to reduce fiscal concessions and housing subsidies. The effects of that action had been to generate a procyclical public sector borrowing requirement and at the same time to pre-empt the major source of nonbank finance. Especially since domestic savings had been declining through much of the 1980s, there was, therefore, a legacy of external debt and, as domestic monetary financing had continued, accelerating inflation. The latter had not only further stimulated real wage growth, but also appeared to be undermining general financial confidence. To complete the circle, it seemed that efforts to shore up confidence had pushed real interest rates to levels that created demands for subsidies, such as the housing finance system, but which might not be adequate to compensate for inflationary expectations, while trapping the economy in an increasing indexation ratchet.

Those developments were particularly worrying because the recovery in fishing that had accommodated the underlying deterioration might be peaking as capacity constraints were reached, Mr. Enoch noted. Given the appreciation of the real effective exchange rate, which had resulted from a policy of maintaining the nominal value of the krona while inflation accelerated, Iceland might have retarded efforts to adequately diversify its export base away from fishing. It was worrying that the current account had been deteriorating at a time when exports might have been at their cyclical peak.

While it was easy to set out the problem, the solution, particularly within political and social constraints, was admittedly much harder, Mr. Enoch said. However, a number of elements had to be included in any attempt to address Iceland's problems. First, given the absolute priority attached to low unemployment, it was vital to ensure that the labor market was very efficient and that the target level of unemployment provided the flexibility to facilitate frictionless redeployment of labor. The current 0.5 percent rate of unemployment could represent as few as 600 people. Most important, the target of more or less full employment could not be sustained without moderation in real wage demands. Second, there was an urgent need to reduce the imbalance between fiscal and monetary policy, primarily by reducing the distortion to the credit system by the housing financing system so as to limit nonbank financing and moderate real interest rates. In fact, given the rapid growth in real wages, was that general subsidy any longer necessary for other than

low-income groups? Third, after those needs had been met, producing some moderation in inflationary pressures, there had to be a restoration of general financial confidence including, in due course, a rolling back of indexation, which could only serve to underpin inflation. Finally, the cumulative loss of external competitiveness had to be restored eventually by a correction of the real effective exchange rate. Ideally, that would be achieved through the control of inflation rather than through nominal depreciation, which, particularly in the case of an open economy like Iceland's, was likely to feed through rapidly to prices and wages. However, a correction of the exchange rate would be counterproductive without adequate support from appropriate budgetary and monetary policies.

The Icelandic authorities had taken a number of measures in the second half of 1987 that had helped reverse the economy's negative trends, Mr. Enoch noted. In addition, an extremely impressive program of structural reform had been implemented--in particular, price deregulation, financial sector restructuring, and continuing tax and tariff reforms, which should increase economic efficiency, thus supporting improved economic performance over the coming few years. He hoped that Iceland could continue its macroeconomic adjustment at a similar pace so as to exploit the potential benefits of its structural efforts. While he did not wish to diminish in any way the authorities' achievements, and he sympathized with their view that structural efforts had been paid scant attention, commensurate macroeconomic reform was necessary to release the resources required to exploit the increased allocative efficiency.

The 1988 budget, which was slightly less ambitious than originally proposed, might not be adequate to continue the recent improvements in the economy, Mr. Enoch suggested. He therefore strongly encouraged the authorities to monitor developments carefully, and he welcomed their declared willingness to consider further measures if their projections proved overoptimistic. He had little doubt that the authorities were committed to achieving rapid stabilization, although they would, of course, be subject to political and social constraints. He could therefore support the proposed 24-month consultation proposal; if the economic situation deteriorated too far, the Board would have the option of interrupting the cycle.

Mr. Al-Assaf noted that the latest Article IV consultation report on Iceland clearly indicated that the economy had been overheating for some time. It also showed that a stage might have been reached at which further delays in adjustment would only make matters more difficult. To some extent, the authorities had already tried twice--in July and October of 1987--to curb global demand. The effects of fiscal and monetary measures implemented on those occasions had been positive but not sufficient. The authorities consequently intended to tighten monetary and fiscal policy further, which, again, might not be sufficient, owing mainly to the combination of the significant increase in real wages with the appreciating exchange rate.

The staff report made it clear that the authorities were not currently contemplating any action on the exchange rate, Mr. Al-Assaf noted. To some degree, that was understandable, as the exchange rate was likely to influence the outcome of the 1988 wage settlement--a matter to which the authorities were attaching much importance--and in view of the strength of wage pressures in a labor market characterized by a virtual absence of unemployment. However, perhaps the authorities were giving too much priority to securing a satisfactory wage settlement. Experience indicated that wage settlements might not be able to prevent further increases over and above the initial rate, especially in situations in which labor demand was as strong as it was currently. If that was so, the price paid for an initially satisfactory wage settlement--i.e., a further deterioration in the external account--might be high.

It was perhaps in that context that the evolution of the external accounts over the coming few months would warrant close monitoring, Mr. Al-Assaf said. The latest available information indicated that the doubts expressed in the staff report about the 1987 trade balance were justified. A further deterioration in the course of 1988 would warrant a reconsideration of available policy options. It would seem appropriate, in such a case, to envisage a broader use of policy tools.

Mr. Wenzel noted that the background paper conveyed rather disappointing news; it was clear that the adjustment gains achieved in 1986 could not be maintained and indeed had been reversed during 1987. Moreover, according to the staff's scenarios, it appeared that the medium-term outlook included continuing substantial financial imbalances, and the scenarios underlined the need for comprehensive and swift corrective measures by the authorities.

He agreed with the staff that, to reduce economic imbalances, the authorities should direct their efforts toward a significant strengthening of fiscal and monetary policy, and that they should aim at restraining real wage increases, Mr. Wenzel said. While he welcomed the reforms already taken on the fiscal revenue side and those envisaged for the current year, he nonetheless felt that fiscal adjustment should be accelerated. In particular, a surplus in the operational budget would be desirable. The necessary reduction in budgetary expenditure would not only help restrain excessive domestic demand, but also help improve the public debt situation. Those measures were all the more important since there was clearly a possibility that the wage negotiations currently under way could lead to substantial real wage increases during 1988, despite the authorities' good intentions.

To the extent that the authorities' room for maneuver was rather limited after the enactment of the 1988 budget, the additional adjustment burden might have to be carried by monetary policy, including exchange rate policy, Mr. Wenzel went on. While a tighter monetary policy was likely to lead to higher domestic interest rates in real terms, and might adversely affect private sector activity, it was hard to detect an alternative course of policy action that could lead to financial stability.

While he recognized the authorities' concerns about the inflationary impact of an exchange rate depreciation, he believed that a correction of the exchange rate should not be excluded from the needed adjustment measures, given the sharp drop in competitiveness evidenced by the widening of the current account deficit in 1987, Mr. Wenzel said. That did not mean, however, that inflationary considerations could be neglected. Inflation needed to be contained, primarily through adequate monetary and fiscal policies.

He commended the authorities for their commitment and efforts to improve the structure of the economy and to reform the financial sector, Mr. Wenzel concluded. The financial reforms, in particular, could facilitate the task of reducing domestic demand and the external imbalance through an increase in domestic savings. He supported the staff appraisal.

The staff representative from the European Department, in response to a question on the realism of the expectation that real wages would remain unchanged in 1988 from the revised 1987 level, said that that had been one of the differences of views between the staff and the authorities during the Article IV consultation. The staff did not consider that existing or announced policies would produce a constant real wage level, and that view was therefore reflected in the staff report's economic outlook.

The effect of high real interest rates on investment was not yet visible; fixed investment had risen 12 percent in real terms in 1987, the staff representative pointed out.

Chart 12 in the background paper referred to annual exchange rate averages, showing an appreciation of about 15 percent since 1985, the staff representative said. The level at the end of 1987 was about 6 percent higher than the average level, or 22 percent above the average level for 1985.

When the staff had been in Reykjavik, details on the introduction of exchange rate-linked deposits had not been available, the staff representative from the European Department indicated. However, in the meantime, the staff had learned that, as the intention was to improve domestic savings, rather than to protect foreign exchange reserves, the deposits would be limited to blocked time deposits with a maturity of six months, and would not include demand deposits.

Mr. Ovi said that the exchange rate-linked deposits could be in SDRs and in ECUs only; the authorities had clearly tried to limit the scope for speculation.

Because of the large size of the fishery sector in Iceland, the economy had experienced sizable swings, Mr. Ovi observed. The latest swing was on the upward side, although the fishery sector had recently experienced a very substantial downfall. The real effective exchange rate appreciation was a natural result of that upward trend.

The Government that had come into office in the past year had very firm policies on structural changes in a number of areas, but the results would materialize only after some time, Mr. Ovi said. At the same time, the Government had had to deal with increasing short-term problems in a number of areas. The important point was that structural adjustment would be a valuable vehicle for conducting firmer adjustment policy over time.

While Iceland had often experienced strong inflationary trends in the past, the governments over the past few years had been trying increasingly to bring about domestic adjustment, Mr. Ovi noted. As part of previous wage settlements, there had often been fiscal concessions, as had been the case in 1986. The new Government was very aware of the substantial costs of such concessions. During the past year it had tightened the fiscal situation on several occasions, and it had worked toward balancing the operational budget in 1988. Due to those efforts, and because several expenditure increases had been proposed during budget discussions, there had been a need to raise tax revenues in order to safeguard the budget balance. In the original budget proposal, the sales tax on food items had been planned at 10 percent for the remainder of 1987. As part of the budget negotiations, the Government had decided to make the 25 percent sales tax rate uniformly applicable from the outset of 1988. Politically costly action was being taken by the authorities to achieve domestic adjustment.

The exchange rate policy had increasingly been used to foster domestic price and wage stability, Mr. Ovi continued. The Government clearly wished to put pressure on the industrial labor market in the area of wage settlements; the cost of the rapidly appreciating exchange rate should be felt by, and should result in losses for the least profitable enterprises in industry. Unfortunately, the Government had run out of time somewhat earlier than expected. Serious consideration of overall economic adjustment was now under way. A viable income settlement and external adjustment had to be implemented hand in hand; they could not be separated. The Government intended to maintain external pressure on the economy for adjustment.

Regarding real wage increases for 1988, there had been some wage overhang, but, due to the tax reform, that surplus had essentially been taken away at the beginning of the year. Fiscal balance seemed to be maintained. The outcome of the ongoing wage negotiations was not yet known. Certainly, there were worrying short-term elements in the Icelandic economy, but the long-term adjustment over the past three or four years had been very positive; that perspective had to be kept in mind when analyzing the Icelandic case. The external debt situation had improved substantially, and the present Government had shown a remarkable willingness to act; there was no reason to believe that it would not continue to do so.

The Acting Chairman made the following summing up:

Directors noted that in 1987 economic expansion in Iceland was driven by domestic spending. Concern was expressed that despite a continued improvement in the terms of trade and another record fish catch the external current account had moved into a widening deficit. Labor market conditions had also become extremely tight and labor shortages had intensified, putting upward pressure on wages and inflation. Directors believed that the Icelandic authorities should give higher priority to price and external stability as well as greater flexibility in the labor market.

Directors observed that the period of rapid growth appeared to be nearing an end. Marine production was expected to have peaked while the terms of trade were unlikely to improve. Thus, the purchasing power of exports was likely to rise little, if at all, in 1988. Directors commended the considerable efforts at structural reform in recent years, particularly in the areas of taxation, financial markets, and fisheries policy. However, they felt that unless domestic demand was restrained, internal pressures would cause a further substantial deterioration in the balance of payments.

Directors stressed that tighter financial policies were urgently needed. The balancing of the 1988 operational budget was seen as a step in the right direction, although reducing the public sector borrowing requirement to a level that could be financed in a nonmonetary manner would probably require moving the operational budget into significant surplus. While welcoming the recent tax reforms, Directors stressed that further fiscal efforts should focus on restraint of current expenditure. Moreover, despite higher real interest rates, domestic credit expansion had remained high, putting pressure on the external accounts. Greater credit restraint clearly was necessary. The indexation of financial instruments was seen as hampering the conduct of monetary policy and as becoming a structural problem which the authorities were encouraged to tackle.

Directors also voiced concern about the large appreciation of the real exchange rate, which had put pressure on the tradable goods sector. While most speakers noted that there was little benefit in using the exchange rate in an overheated economy, except perhaps as a holding action, Directors stressed that a review of exchange rate policy might well become necessary to prevent a serious deterioration in the balance of payments and eventually in economic activity. They hoped that exchange rate action would be part of a larger policy package, including appropriate wage restraint, which should be introduced with a minimum of delay.

Iceland is on a bicyclic consultation procedure. It was agreed that the next Article IV consultation with Iceland would be completed in 24 months unless, as noted by some Directors, the economic situation continues to deteriorate significantly.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/88/11 (1/29/88) and EBM/88/12 (1/29/88).

4. EXECUTIVE BOARD TRAVEL

Travel by an Assistant to Executive Director as set forth in EBAP/88/26 (1/28/88) is approved.

APPROVED: October 6, 1988

JOSEPH W. LANG, JR.
Acting Secretary