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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 87/130

10:00 a.m., September 4, 1987

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
A. Abdallah	
Dai Q.	
	M. K. Bush
	D. C. Templeman, Temporary
	J. Prader
	L. Hubloue, Temporary
A. Donoso	
	M. B. Chatah, Temporary
G. Grosche	B. Goos
J. E. Ismael	J. Reddy
	J. Hospedales
	J. E. Zeas, Temporary
	M. Foot
J. Ovi	M. Fogelholm
M. Massé	D. McCormack
Mawakani Samba	
	I. A. Al-Assaf
G. Ortiz	L. Filardo
	F. J. Fernandez, Temporary
	G. Pineau, Temporary
G. A. Posthumus	
	C.-Y. Lim
	I. Sliper, Temporary
G. Salehkhou	O. Kabbaj
	L. E. N. Fernando
K. Yamazaki	
S. Zecchini	

L. Van Houtven, Secretary and Counsellor
R. S. Franklin, Assistant

Also Present

IBRD: D. R. Bock, Director, Debt Management and Financial Services Department. African Department: P. Marciniak. Asian Department: D. A. Lipton. European Department: M. Guitián, Deputy Director; J. J. M. Kremers, D. C. L. Nellor, K. Saito, G. S. Tavlas, S. M. Thakur, H. Vittas. Exchange and Trade Relations Department: J. T. Boorman, Deputy Director; S. J. Anjaria, A. Ariyoshi, C. Atkinson, E. Brau, K. B. Dillon, L. H. Duran-Downing, J. Hicklin, H. B. Junz, S. Kanesa-Thasan, G. R. Kincaid, P. J. Quirk, K. P. Regling, L. M. Valdivieso, C. M. Watson, M. Xafa. External Relations Department: A. F. Mohammed, Director; D. M. Cheney, P. C. Hole, H. P. Puentes. Fiscal Affairs Department: A. Cheasty. IMF Institute: O. B. Makalou. Legal Department: H. Elizalde, J. M. Ogoola. Research Department: J. A. Frenkel, Economic Counsellor and Director; A. D. Crockett, Deputy Director; M. Goldstein, Deputy Director; R. R. Rhomberg, Deputy Director; M. P. Dooley, D. Folkerts-Landau, D. J. Mathieson, P. Wickham. Secretary's Department: C. Brachet, Deputy Secretary. Treasurer's Department: T. Leddy, Deputy Treasurer. Western Hemisphere Department: S. T. Beza, Director; J. Ferrán, Deputy Director. Bureau of Statistics: J. B. McLenaghan, Deputy Director; C. Briançon. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: E. Ayales, A. Bertuch-Samuels, L. P. Ebrill, A. G. A. Faria, A. Ouanes, P. Péterfalvy, I. Puro, A. Vasudevan, K. Yao. Assistants to Executive Directors: A. R. Al-Abdullatif, F. E. R. Alfiler, J. R. N. Almeida, M. Arif, O. S.-M. Bethel, E. C. Demaestri, S. K. Fayyad, S. Guribye, M. A. Hammoudi, M. Hepp, G. K. Hodges, S. King, K.-H. Kleine, K. Kpetigo, M. Lundsager, V. K. Malhotra, T. Morita, D. V. Nhien, C. Noriega, L. M. Piantini, S. Rebecchini, S. Rouai, D. Saha, G. Seyler, H. van der Burg, Yang W., I. Zaidi.

1. IRELAND - 1987 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1987 Article IV consultation with Ireland (SM/87/199, 8/7/87; and Sup. 1, 9/1/87). They also had before them a background paper on recent economic developments in Ireland (SM/87/216, 8/20/87).

Mr. McCormack made the following statement:

The Irish economy in the 1980s has been marked by severe economic and financial imbalances. These reflected the second oil shock and the associated international recession but also in part what, in retrospect, can be seen as procyclical fiscal policies pursued in the late 1970s. The year 1981 saw the external and internal imbalances at their most acute. The external current account deficit was almost 15 percent of GNP, the rate of inflation exceeded 20 percent, and the Exchequer borrowing requirement was 16 percent of GNP. Unemployment in 1981 reached 10 percent, a fairly high rate by previous standards but one which was to almost double within the next five years.

Successive governments sought to grapple with these imbalances throughout the 1980s, and some successes were achieved. Inflation fell sharply to its present rate of about 3 percent, one of the lowest in the OECD area. The balance of payments deficit on current account was brought down substantially and this year is expected to be about 1 percent of GNP. Interest payments on external public debt constitute a major factor accounting for the deficit. In 1987, Ireland is expected to record a substantial trade surplus for the third successive year. However, two problems remained intractable: the disturbingly high rate of unemployment; and the persistence of fiscal deficits on a scale which was clearly unsustainable in the long run.

A new government took office in March and moved quickly toward the correction of the acknowledged economic and financial imbalances. The Government is strongly committed to the sustained pursuit of a consistent set of macroeconomic policies designed to enhance economic performance by improving competitiveness and correcting the imbalances in the public finances. These policies entail a budgetary strategy, an incomes policy and an exchange rate strategy and are supported by a wide-ranging program of structural measures designed to promote economic development.

Despite efforts to curb fiscal deficits in previous years, the deficit remained large, and public debt continued to rise in relation to GNP. This reflected in large measure the powerful dynamics at work between high initial levels of outstanding debt and heavy debt service commitments, particularly in an environment of high interest rates which feed into higher debt levels. Thus, the Exchequer borrowing requirement (EBR) in 1981 was 16 percent of GNP while the EBR net of interest (the so-called primary deficit) was 9 percent of GNP. By 1986, the primary deficit had been reduced to less than 2 percent of GNP and yet the EBR was still 13 percent of GNP because of rising interest charges.

In the light of these considerations, the Government's basic budgetary objective is first to halt and then reverse the increase in the debt/GNP ratio. The Government is determined to bring about a reduction in the level of annual borrowing as quickly as possible. In the 1987 budget, introduced within three weeks of the Government taking office, the Government introduced a wide variety of measures aimed at reducing the current budget deficit and EBR by 1.6 percent and 2.3 percent, respectively, compared with the outturn for 1986; these reductions were significantly larger than those contained in the outgoing Government's budgetary proposals. The present program of adjustment will be maintained into 1988 and beyond.

In achieving fiscal adjustment, the authorities intend, given the parallel objective of promoting competitiveness, to concentrate on expenditure retrenchment. This year's budget included cutbacks in health expenditure and housing subsidies, introduction of new health charges, an embargo on new recruitment in the public service and a public sector pay freeze in the second half of the year. None of these measures was popular and each met with opposition from the affected interest groups. However, the Government has maintained a firm line and is confident that its objectives will be attained this year. It will take prompt compensatory action if shortfalls begin to emerge. Further retrenchment will require severe policies across the whole range of programs. A fundamental review of expenditure programs has been undertaken through the summer with the objective of settling the 1988 expenditure estimates and setting necessary policy measures in train to realize further fiscal improvement.

The Government is conscious of the need to reform the tax system both in the interests of equity and to improve resource allocation, in particular to improve the balance between the costs of labor and capital. It is the Government's intention, as soon as circumstances permit, to move to a stage where two thirds of taxpayers will pay tax at the standard rate only; over 43 percent of taxpayers at present are subject to higher rates of tax. This policy, when implemented, would be expected to reduce significantly the distortions in the present system which adversely affect the operation of the labor market and the economy generally. Also, the Government has announced a review of the corporation tax system which will focus on the feasibility of reducing capital allowances and the standard rate of corporation tax. This approach could help reduce the present bias toward capital/labor substitution.

My authorities attach the greatest importance to the maintenance and enhancement of competitiveness, in its broadest dimensions. They recognize that this is the key to the promotion of economic growth and employment opportunities. However, the authorities do not view a change in the exchange rate, combined with nominal wage restraint, as a practical means of improving competitiveness.

The main consideration underlying Ireland's exchange rate policy has been the view that, for a small open economy, exchange rate changes are not a good instrument for achieving economic objectives such as improved competitiveness. Past experience suggests that the adverse price effects of a currency depreciation tend to feed through quickly and erode the beneficial effects, leading to no long-term real benefits but only to a higher level of inflation. A policy of stabilizing the nominal value of the currency--using the exchange rate as the nominal anchor of the economy--reduces uncertainty for traders and asset holders, with beneficial effects on trade and interest rates. Accordingly, the policy has been to keep the Irish pound in the middle group in EMS realignments, neither revaluing nor devaluing. However, the volatility of major currencies, such as the pound sterling and the U.S. dollar, over the past few years has complicated the task of exchange rate management for a number of small countries, including Ireland. It was in the context of such volatility that the initiative was taken, quite exceptionally and as a pre-emptive measure, to realign the pound in early August 1986. No further downward adjustment is envisaged.

Given the exchange rate strategy, the Irish authorities concur with the staff on the necessity for income restraint. No opportunity has been missed to emphasize the link between pay developments, competitiveness and employment. The budget, by freezing public service salaries, gave a clear pledge of the authorities' intentions. For the future, it has been made clear that the public sector wage bill cannot again increase at rates in excess of inflation.

Since the staff mission to Ireland, the level of wage settlements has continued to moderate, but slowly. Recent settlements, on average, have involved annualized increases of about 5 percent. However, if the pattern of earlier pay rounds is repeated, further moderation can be expected as the round progresses and as participants on both sides of the wage bargaining process come to accept the reality of the most favorable inflationary climate in two decades. One further point may be worth noting. Some commentators have seen evidence of the growth of an "outsider" labor market in which pay and conditions of work are less favorable than those enjoyed by the majority of the unionized labor force. This would suggest a greater degree of labor market flexibility than is apparent from consideration of standard statistical data.

Following the budget in March, there have been a number of welcome signs that confidence is being restored. Financial markets have reacted very positively to the budget and to the growing evidence subsequently that the authorities were standing firm, even in the face of quite intense social and political pressures. Market interest rates have fallen steadily, and it has been possible to unwind completely central bank support to the money market. Lower market rates have been reflected in downward adjustments in bank lending and deposit rates. Banks' prime lending rates now stand at 10 1/4 percent, more than 3 percentage points below the rates prevailing at the beginning of the year.

The latest official forecast for the Irish economy in 1987 is for an improvement in overall economic performance relative to last year. Growth, although modest, will come from the internationally traded sectors. With export growth accelerating, the external account should improve further. Inflation is set to stay at a low level. While the short-term outlook for employment in manufacturing is improving, overall employment is, nevertheless, not expected to increase. Unemployment will show a further rise with net emigration remaining unchanged. A slowdown in job losses, however, indicates that the foundations for a sustainable expansion of output and employment are being laid.

The authorities have taken significant steps this year toward budgetary adjustment but recognize that more needs to be done. They have begun the process of developing a medium-term program designed to tackle the problems confronting the economy and to develop measures to stimulate growth. The basic framework for this program is a detailed study prepared late last year by the Government's advisory body, the National Economic and Social Council, a body on which the social partners are represented. The Government believes that such a program needs to be based on a realistic consensus with the social partners and to that end has entered into a dialogue with them to turn the broad principles, on which there is now general agreement, into a practical and detailed program of action covering the next three to five years.

Finally, my authorities wish me to convey to the staff their appreciation for the friendly, constructive, and challenging way in which the consultations were conducted and for the excellence of the reports produced.

Mr. Foot observed that the new Government was to be commended for having come rapidly to the conclusion that Ireland's problems were serious and for looking ahead to what needed to be done. Some important steps had already been taken in tackling those problems. The key area of concern was the fiscal side, and the authorities recognized that it was essential to resolve the fiscal problem if the economy was to be put on a sustainable path. The rapid accumulation of debt witnessed in recent years could not be allowed to continue for much longer; and, while recently adopted measures were certainly aimed in the right direction, they would need to be maintained and built upon.

It was particularly welcome that the early steps taken by the authorities had been geared toward expenditure restraint, Mr. Foot continued. The share of noninterest current expenditure and GDP had hitherto been on a rising trend, and it was particularly encouraging to see that the authorities were conducting a far-reaching review of expenditures. Lasting restraint could come only from such a review and from an education of the public. It was to be hoped that the review would cover in detail wage and salary policy, because expenditures on wages and salaries seemed to have continued to increase strongly in the past year, despite the wage freeze and the planned reduction in the number of civil servants. Social security payments also would need to be examined, particularly as replacement ratios generally seemed to be high. In that connection, he wondered whether the possibility of taxing social security benefits was a matter that deserved scrutiny at an early stage.

Of course, revenue enhancement could not be forgotten, Mr. Foot continued. And he would be interested in hearing how the staff viewed the current burden of taxation on agriculture, a sector that had been traditionally taxed lightly but where some changes had apparently been made in recent years. More generally on the fiscal policy stance, it seemed to him that Ireland's case provided one example of why his authorities felt that the primary fiscal deficit concept had its limitations. As Mr. McCormack had noted, the primary balance had improved sharply in recent years, while the actual deficit had remained at a high level. Once the debt burden reached high levels, there was a danger that a vicious circle could occur in which rising interest payments drove up the deficit, and vice versa. It was easy to imagine such a situation getting out of hand, even if the primary balance appeared to be modest.

Firm action on the fiscal front would need to be accompanied by far-reaching structural measures to ensure reductions in the currently high level of unemployment, Mr. Foot considered. Of particular importance was the question of how far government policies had led to distortions in the relative prices of capital and labor; and the Appendix in SM/87/216 had been instructive in that regard. The interaction of the corporate and personal income tax systems seemed to have increased the price of labor relative to that of capital, and the effects of that interaction on the productive sector were apparent. It was thus encouraging to note that the authorities were aware of the problem and, while a full solution to the problem would no doubt have to await a stronger fiscal position, there might be several steps that could be taken in the interim. Certainly, something must be done to stem the emigration among the young by boosting opportunities. Given the long intermittent history of emigration of the young and the able from Ireland, the Irish Government must work to ensure that the fruits of its lengthy investment in human capital were reaped at home rather than abroad.

In conclusion, Mr. Foot observed that the authorities had made an important step toward putting the Irish economy on to a more sustainable growth path. Much remained to be done, but the current environment--both within Ireland and in its major overseas market, the United Kingdom--was supportive of progress. He hoped that progress would occur at a pace sufficiently rapid to enable the placement of Ireland firmly on a bicyclical consultation process within a year's time.

Mr. Sliper made the following statement:

Ireland's performance over the last year or so has been mixed. There have been some encouraging developments: for example, the record of inflation of under 3 percent in the last year is a very positive sign; similarly, the improvement in the external position, with a current account deficit of just over 1 percent, is a satisfying state of affairs. Nevertheless, Ireland's position remains clouded by the very large fiscal deficit and by an unemployment level of about 18 percent, a figure which it can be argued actually understates the employment problem because of the high rate of emigration which has occurred recently.

I shall confine my remarks basically to the fiscal situation and, particularly, the appropriate pace at which the deficit should be reduced, which, in my view, remains the crucial policy question facing the authorities. The situation is of course exacerbated by the huge level of debt that has built up in recent years. Appendix III of SM/87/216 contains some interesting analysis of the speed at which the fiscal deficit must be reduced in order to stabilize the debt position. The conclusions are clear: there must be some very substantial reductions in the noninterest part of the public expenditure, and the measures must be frontloaded.

The enormity of the fiscal adjustment task cannot be underestimated. The level of unemployment makes accomplishment of the task more difficult; however, it is a task that must be undertaken if confidence and sustained growth are to be seen again in Ireland.

In this regard, I have some doubts about whether the Government and the people are yet ready to embark on the fiscal consolidation exercise that is required over the next few years. I realize that the Government is going through a process at the moment in which Ministers and departments are being asked to examine areas where expenditures might be cut. It also seems apparent that the Government is engaged in an important dialogue with the social partners. However, what is missing at present is an indication of broad strategy on where the government expenditure program might be cut. It seems to me that for the Government to create a climate for change, it has to get out in front and indicate areas, or programs, or ideas for fiscal reduction. Reading the staff report, I get no such sense of direction; there is no mention of privatization programs, or reductions in subsidies, or cutbacks in welfare payments. Similarly, I do not get the feeling that the Government is taking the lead in encouraging people to change their attitude about the role of government. Historically people have been encouraged to believe that the public sector can provide most of the goods and services; they must begin to understand that a vigorous outward-looking private sector should be the main vehicle for providing jobs and growth.

In the case of Ireland, the pace of adjustment is going to present an enormous problem. The dangers of adjustment fatigue are real. My question for the staff and Mr. McCormack is whether the framework of the medium-term fiscal strategy has begun to take shape. Are the authorities yet getting to the point of translating all the discussions and dialogue into a concrete plan of action?

Mr. Templeman made the following statement:

At the time of the Board's discussion of the new bicyclical consultation procedure, we proposed that Ireland continue on the standard 12-month cycle. While we remain willing to go along with the wish of the Irish authorities to move to the bicyclical procedure, it seems to us that this examination of the Irish economic situation, provides rather strong evidence of the need for close monitoring of economic developments there.

I fully recognize and commend the very real progress made in cutting Ireland's external deficit and in sharply reducing its inflation rate. But the economic inheritance from past policies includes an unsatisfactory position as regards investment and economic growth, job creation and unemployment, foreign and domestic debt, and structural rigidities in the labor market and fiscal areas. For example, over the past four years, economic growth has stagnated; gross fixed investment has been negative; total employment has fallen; the unemployment rate is among the highest in the industrial world, and long-term unemployment accounts for 60 percent of the total; the national debt has climbed to over 150 percent of GNP and the external public debt ratio to over 74 percent; the public sector borrowing requirement (PSBR) last year exceeded 15 percent of GNP; the tax system seems badly in need of reform; and labor market rigidities continue to limit employment prospects and contribute to wage pressures.

Fortunately, there have been some recent positive developments, including export expansion, greater stability in financial markets, somewhat better economic growth prospects and initiation by the new Government of some steps toward resolving critical fiscal and labor market problems over the medium term.

Appendix III to SM/87/216 cites three conclusions of a study of "The Dynamics of Fiscal Adjustment in Ireland": first, that Ireland needs to adopt a medium-term strategy to minimize budgetary uncertainty with its adverse influences on interest rates and economic growth; second, that there is little leeway for avoiding a substantial frontloading of such fiscal adjustment; and, third, that success in promoting economic growth would reduce the scale of fiscal adjustment needed.

In fact, the 1987 budget does provide for some revenue and spending measures aimed at heading off a rise in the Exchequer borrowing requirement from about 13 percent of GNP (without the measures) to 10.7 percent of GNP, including some politically sensitive expenditure cuts. This is a useful start toward the fundamental fiscal adjustment that is still required. The size of the fiscal and related economic problems can be seen in the revenue ratio of nearly 48 percent of GNP and the expenditure ratio of almost 59 percent in the 1987 budget. Similarly, interest on the public debt would exceed 23 percent of current expenditures and 27 percent of current revenues, indicating the extent to which the hands of the authorities are already tied by the inheritance of past budget deficits. This underlines the importance of the ongoing review of expenditures and the current talks with the social partners as a means of addressing the unsustainable fiscal situation that has emerged in recent years.

The need for tax reform, also, seems quite clear from the wide array of weaknesses cited on page 11 of the staff report, including the narrow tax base for both direct and indirect taxes, tax evasion by the self-employed, a marginal personal income tax rate of 58 percent, which applies to more than 40 percent of taxpayers, and the undesirable effects of tax and spending laws in favoring capital-intensive investment in the face of very high unemployment and declining employment. While admittedly there is little room for loss of revenues, we would strongly urge that work begin soon on tax reform.

This brings me to the need for simultaneous correction of fiscal and labor market problems, if fiscal imbalances are to be cured in the context of economic growth and job creation. For example, Appendix I to SM/87/216 notes that "government policies have impinged on the operation of the labor market. This applies in particular to industrial policy, the system of wage determination, the social benefit policy, and the tax system." The Appendix does indicate that, in recent years, under a decentralized system of wage determination, there has been somewhat greater divergence in the rates of wage increases, but that the distortions associated with the social benefit and tax systems have increased despite some offsetting action by the authorities.

The staff report suggests that Ireland's competitiveness suffered during 1986, and it stresses the need to contain real wages to protect Ireland's balance of payments position, particularly in the context of the exchange rate constraints imposed by the EMS. But, wage restraint is at least equally important if Ireland is to create greater incentives for labor mobility and job creation at home.

Finally, considerable success has been achieved in reducing the ratio of the current account deficit of the balance of payments to GNP, from about 7 percent in 1983 to 2 percent last year. Also, the staff's medium-term scenarios suggest that future deficits can be contained to rather modest amounts. The difficulty lies with the past accumulation of very large amounts of foreign debt—comparable to that of some of the more indebted developing countries. Fortunately, the authorities have been able to maintain Ireland's creditworthiness in international markets and, recently, they have succeeded in improving the debt structure. Still, any further increase at all in foreign public debt will add to the already heavy burden imposed on both fiscal policy and on the balance of payments situation. Clearly, there is no time to lose in moving forward on fundamental reforms.

Mr. Goos said that he was in full agreement with the staff appraisal of, and policy recommendations concerning, the Irish economy. It was regrettable that the recommendations differed little from those expressed in previous years and that the staff had had to focus on largely unchanged problem areas. However, he was encouraged to note that the new Government had recently taken a number of policy measures and initiatives that, in his view, held the promise for a fundamental improvement in economic performance.

On specific policy issues, he had little to add to the comments of previous speakers, especially since Mr. McCormack's opening statement revealed that the authorities were generally in agreement with the staff's assessment of the economy, Mr. Goos continued. Nevertheless, he felt it necessary to echo the concerns of others about the pace envisaged for the reduction of the fiscal deficit. There was some risk that the burden of fiscal adjustment might eventually reach unmanageable levels. To be sure, the authorities had already taken important steps, including painful cuts in social expenditures; but political reality suggested that such unpopular measures--which would undoubtedly need to be repeated in other areas--tended to become increasingly difficult to implement as government election time drew near. He hoped in the circumstances that the authorities would not miss the opportunity to "frontload" their adjustment strategy as much as possible and would specify the areas for further adjustment without delay.

Welcoming the authorities' intention to reform the tax system and, in particular, to reduce the excessive taxation of wage incomes, Mr. Goos observed that lowering effective real wages was crucial to the success of the authorities' adjustment strategy and should therefore be pursued as a matter of priority. However, a note of caution was in order. Tax reductions introduced toward that end in other countries had often proved to be a double-edged sword. In the first round, such reductions had tended to be quite successful in buying wage concessions from labor unions, but when the underlying causes of the wage pressures went untackled, the authorities in the second round had usually found themselves faced with renewed excessive wage demands and, at the same time, with an increased fiscal burden as a result of the tax reductions. In the end, therefore, they had often been worse off than before. Such experience led him to make two points in the context of the Irish economy. First, it suggested that tax reductions should be granted only when offsetting fiscal measures were in place, and he agreed with the staff that there was scope for such measures. Second, the authorities should embark on tax reductions only after having received the firm assurance of the social partners that they would cooperate in containing wage pressures.

In conclusion, Mr. Goos welcomed the authorities' decision to reduce pay-related unemployment benefits, which appeared to be clearly excessive. Their action should strengthen the incentive to work and, thereby, stem the growth of the outside labor markets.

Mr. Prader made the following statement:

> The staff report shows that the record of the Irish economy over the course of the 1980s has been consistently poor in some areas, with stagnant or declining growth accompanied by an explosion of unemployment and foreign debt. Also, the unfavorable divergence between the Irish economy's performance and the OECD-Europe average indicates that some major policy mistakes must lie at the root of this malaise, and we suspect that the improvements in some key indicators such as inflation, the growth of exports and manufacturing production are less significant than the directions of economic policy outlined by the new Government. We share the view that the courageous new policies focusing on substantially correcting the fiscal imbalances will increase the long-term growth potential of the economy by reviving the private sector, stabilizing--and possibly bringing down--the debt/GDP ratio, and lowering interest rates.
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> By concentrating on expenditure reduction rather than revenue enhancement, the 1987 budget measures aimed at reducing the Exchequer borrowing requirement seem to set a correct course, since the already heavy tax burden does not leave much room for further revenue action. But cuts in public spending, even if they are applied across the whole range of expenditure types currently under review by the authorities, will not alone be sufficient. On this point the staff's scenarios of fiscal adjustment are very useful in pointing up the need to complement these policies by restraining increases in public service pay.

Indeed, one of the surprising features of the Irish economy is the absence of any sizable effect on wage restraint of the dramatic rise in unemployment. Unemployment has nearly doubled since 1980 to some 19 percent in 1987, a level which far exceeds the average for OECD-Europe. If declining participation rates and emigration had not at least partly offset this increase, the results would have been even more distressing. Yet the growth of nominal wages has hardly been affected; nor have real wages responded much to the changed economic conditions. Instead, in line with what seems an unfortunate tradition, current wage settlements provide for increases well above the CPI.

Appendix I to SM/87/216 is very informative with respect to this economic enigma. A number of factors have evidently contributed to the steep increase in unemployment and to the stickiness of real wages: government policies in the labor market, especially industrial policy; the system of wage determination; high unemployment benefits; and the tax system. In view of the crucial importance of wage moderation to the performance of the Irish economy, this dysfunction of the labor market calls for a review and a reform of a whole array of policies. Failure to heed this call would, in the long run, endanger and discredit other economic policies as well, especially in the fiscal and monetary areas.

The staff paper mentions discussions with the Irish authorities on the favorable results obtained by the introduction of decentralized pay bargaining, and discussions between the Government and the social partners on a program for national recovery which might promote wage flexibility. It would be interesting to hear, either from the staff or from Mr. McCormack, about the terms of this agreement and whether it shows an awareness of the need, or even provides measures, for effectively tackling the whole range of social and economic policies involved in restructuring the labor market.

As long as such a social consensus on the priorities and needs of economic policy is not achieved, the skepticism of the monetary authorities over the useful effects of exchange rate depreciation on demand and output is understandable and correct. If, *in fact, government policy were to be limited by the constraint* that the unions would not cooperate with a strategy making greater use of the exchange rate, so that wage increases would wipe out the competitive advantages of a devaluation, then a commitment simply to stabilize the nominal effective exchange rate becomes the only policy option left.

Given the present economic environment, we also tend to think that the emphasis of policy should be on improving competitiveness by containing domestic cost pressures rather than on resorting to exchange rate changes. And yet the trade figures demonstrate that the recent bouyant growth of exports has been due--among other factors--to the depreciation of the real effective exchange rate.

At the same time domestic demand has remained rather weak. Therefore, growth will be dependent on the external sector. In any event, given Ireland's membership in the European Monetary System (EMS) at a time when the United Kingdom is still her largest trading partner and when the movements of the British pound hit hard at Ireland's trade performance, Ireland's situation would be greatly improved if the United Kingdom were to join the EMS.

Mr. Fernandez made the following statement:

I thank Mr. McCormack for having presented a realistic and well-balanced statement on Ireland. Unfortunately, it is not easy to find many positive developments in the Irish economy in 1986. A lower inflation rate and a lower current account deficit than in previous years can be mentioned; however, there are indications that macroeconomic imbalances persist and some rather negative results have been seen: growth of GDP was close to zero and gross fixed investment decreased for the third year in a row; at the same time, unemployment rose to 19.1 percent in July 1987. Prospects for the near future are not very bright, especially taking into account the uncertainties surrounding the world economic outlook. I hope that the authorities' projections of moderate growth based on export performance and on the recovery of investment will materialize for 1987. To achieve this result, it is essential to support supply-side economic measures in the fiscal and labor market areas with sound macroeconomic policies. In general, the new Government's economic measures are going in the right direction.

The main problem on this fiscal side is the large fiscal imbalance. Unfortunately, this problem is structural in nature, and its correction will require a persistent and well-designed program of fiscal deficit reduction. Such a program can be very unpopular because of the required measures that must be taken on the expenditure side. A halt, or even a decrease, in welfare expenditures in areas such as health, education, and so on, will be needed in the short run to alleviate the constraint on growth that the overlarge fiscal deficit is imposing. However, a certain margin of maneuver for public capital investment would be desirable. The reduction in current expenditures should be strong enough to allow for a tax reform that avoids discriminating against the labor factor, without reducing tax revenues significantly. The tax reform should be aimed at encouraging, through a carefully planned tax structure, both private consumption and investment.

We welcome the new Government's intentions to reduce the Exchequer's borrowing requirements (EBR) in the near future, an approach that is essential in order to stop the rise in the ratio of the national debt to GNP. To achieve this goal, EBR should be substantially reduced over the next few years.

Another concern relates to incomes policy and the labor market. I believe that public sector wages should lead the way toward a strict incomes policy for the economy as a whole. This policy should be based on zero or even negative real wage increases, since relative hourly earnings increases diminish Irish external competitiveness, making export-led growth more difficult. At the same time, a reduction of the public wage bill would help to reach fiscal targets. Wage restraint is an important element in arresting macroeconomic imbalances but should be accompanied by a reduction in income taxes on wage and salary earners to avoid a sluggish increase in consumption and to alleviate the adverse effects of reduced real wages that may result. Furthermore, wage restraint is a necessary condition for improving the unemployment problem under present economic conditions.

Creating new employment opportunities for the unemployed and preventing young people from emigrating are the ultimate goals of Irish economic policy. I share the opinion that a social agreement for economic growth recovery is a prerequisite for decreasing the rate of unemployment and would be advisable in the case of Ireland. Measures such as social welfare expenditure cuts, real wage reductions, and greater labor mobility cannot be put into practice for a sufficiently long period without social consensus between the Government and the rest of the representative political and social forces. In this regard, I would welcome comment from Mr. McCormack on whether or not there is a strong disagreement among political parties and trade unions on the diagnosis of the economic situation and on the economic policy measures on the demand and supply sides of the economy that should be taken in order to address the main problems. If a reasonable compromise can be reached, a social agreement on a comprehensive medium-term economic program could improve significantly the economic atmosphere of the Irish economy, making the Government's economic program of fiscal adjustment more sustainable and credible.

The Irish economic authorities are constrained in the areas of the balance of payments and the exchange rate policy by the EMS mechanism; the role of exchange rate policy in improving the external competitive position is, therefore, quite limited. Thus, firm demand policies are required not just to maintain the value of the Irish pound within the EMS bands, but to improve competitiveness vis-à-vis Ireland's trading partners. Moderation in production costs and sound macroeconomic policies will avoid the emergence of disruptive speculative movements that will negatively affect financial markets and the balance of payments. I would appreciate a comment from the staff on the implications for the Irish economy of having the Irish pound fully integrated in the EMS, especially in the light of recent developments in the Irish foreign exchange market.

Finally, I strongly believe that a comprehensive medium-term economic program that includes consistent and long-lasting macroeconomic and structural measures, is the best way to deal with the fiscal imbalances and the unemployment problem. In the end, a social agreement may be the shortest route to achieving sustainable high rates of economic growth in order to create net employment.

Mr. Pineau made the following statement:

In reviewing the Irish economic situation, one may get the feeling that the adjustment process is only just starting. To be sure, the Irish authorities took some stabilization measures at a rather early stage; however, those efforts never really gathered momentum, and they were even relaxed during the recent period. The renewed awareness of the authorities of the deep-seated nature of the present imbalances, and their apparent readiness to frame the required steps in a medium-term perspective, are therefore welcome.

On the central issue of fiscal retrenchment, as clearly indicated in the appendices to SM/87/216 and as stressed by other speakers, a frontloaded approach appears highly advisable. For the current year, the authorities seem well engaged in this process, with a noticeable cut in the overall public sector financing requirement. Nonetheless, the full stabilizing impact of the fiscal consolidation will hinge on the continuity of action, excluding any backsliding. This would imply the determination of a precise timetable for accomplishing the major fiscal objectives over the next few years. I would like to know from Mr. McCormack or the staff whether the authorities intend to establish a medium-term program.

As far as the magnitude of the fiscal adjustment is concerned, the need for drastic cuts, even in current expenses, is clear. As the capital budget shortfall accounts for a sizable portion of the overall deficit, a frontloading of the consolidation process could be devised through a sharp scaling down of public investment programs. Perhaps Mr. McCormack or the staff could give us additional information on the authorities' intentions in this area.

In the monetary field, the authorities' room for maneuver can only benefit from a significant withdrawal of the public sector. The level of national savings compares rather well with other European countries and can allow a funding of private sector investments at reasonable interest rates. Moreover, a steady lowering of the cost of financial resources with its beneficial impact on domestic investments would lend support to the authorities' evolving approach to foreign investments and their growing reluctance to foster them through special schemes.

The option of exchange rate stability within the EMS appears compatible with the authorities' main policy objectives. Actually, it does not seem to put undue strain on monetary policy. Of course, the special relationship between the Irish pound and the pound sterling continues to generate comparatively large fluctuations in short-term interest rates. Nonetheless, the sharpest movements have proven rather rapidly reversible and, on the whole, the basic interest rate differential with major foreign currencies does not appear excessive.

On competitiveness, the staff is right to stress that cost and price developments must remain under close scrutiny, considering the exchange rate policy option and the recent weakening of export performance. As regards the inflation record, the authorities should be commended for the substantial progress made over the recent period. However, even more than in other European countries, wage flexibility appears too low, despite a very high unemployment rate. Roughly 60 percent of this unemployment is of a long-term nature, which seems to reflect widespread structural rigidities.

The situation in Ireland is a serious one, even by European standards. It can be partially attributed to the split nature of the Irish economy, in which there has not been so far any cross-fertilization between the traditional sector and the capital-intensive industries developed with the support of foreign investments. A better balanced industrialization pattern would certainly be helpful in removing some structural problems, which have an adverse impact on wage formation and labor mobility. Perhaps Mr. McCormack could confirm that his authorities are reviewing the industrialization scheme followed in the late 1970s and early 1980s. Given that the tax system is not providing adequate incentives to work, I would appreciate some comment on the feasibility of early measures in the context of the current fiscal consolidation. Finally, it is to be hoped that Ireland, as a rather late starter in the stabilization process, will be inclined to proceed as rapidly as possible in its adjustment efforts.

Mr. Al-Assaf made the following statement:

The economic imbalances which have emerged over the past ten years or so in Ireland are serious. The Irish authorities have been aware of these imbalances and have taken a number of steps to reduce them. While their efforts have met with some success, notably a sharp reduction in inflation and a significant improvement in the trade account, when measured by quantities such as the fiscal deficit and the debt to GNP ratio, progress has been much slower than desirable. However, all indications are that the authorities recognize the gravity of the situation and feel that a strengthening of adjustment efforts is necessary. I commend them for the steps they have recently taken, especially since some of the measures have been courageous. I am encouraged that the authorities intend to sustain this vigorous adjustment effort into the medium term.

The Irish authorities are facing a dilemma. As can be seen from the medium-term scenarios, if the country is to restore economic balance, then the prospect over the next few years is for relatively slow growth which, in the short run, will increase an already high level of emigration. However, if Ireland is to return to a path of sustained growth with increased levels of employment, there appears to be little choice in this matter: nothing less than a sharp reduction in economic imbalances and a complete overhaul of the incentive structure of the economy will be necessary. Inevitably, in the short run, this will be disruptive; however, the benefits, especially in the form of bolstered confidence, should soon outweigh the costs.

On the specifics of the adjustment effort, as the authorities are well aware, the primary focus needs to be on fiscal policy. Here, emphasis will need to be placed both on reducing the fiscal deficit and on reducing the tax burden. As a result, reductions in expenditure levels will be crucial. Many cuts have already taken place, notably in the capital, health, and education programs. This suggests that a close scrutiny of social welfare benefits, which have recently been increasing in real terms, might now be appropriate. Containing such benefits and transfer payments would not only help with the deficit, but would also reinforce efforts to reduce the high replacement ratio. More generally on incentives, I agree with the staff that the focus should be on reducing the bias in the tax system in favor of capital income.

In conclusion, I note that the Irish authorities have taken a very important step on the path to adjustment. Because of that fact, the outlook has improved considerably over the past year. Nevertheless, it remains for the Irish authorities to sustain their adjustment efforts over the next few years, so as to capitalize on the steps already taken.

Mr. Fogelholm made the following statement:

We share the views and recommendations of the staff and are in broad agreement with comments made by previous speakers, particularly comments emphasizing the need for further strong fiscal policy consolidation.

I would like to thank Mr. McCormack for an extremely frank and informative statement, which took most of the steam out of our own suggestions for possible future policy actions. In fact, it would almost suffice to welcome the new stance of economic policy in

Ireland and only urge the authorities to hold the line in their current efforts to restore balanced economic growth and employment. However, I will comment briefly on one or two items of particular importance to adjustment policies, labor market imbalances and the overall competitive position of the Irish economy.

We find regrettable the high level of unemployment that has lasted for several years. Large social costs are incurred in addition to the implicit costs of unused growth potential. A continued huge emigration of Ireland's young labor force must also constitute a heavy burden on the Irish economy in the long run.

The policy measures needed to restore a more effective labor market are, at the same time, measures necessary to improve the overall performance of the Irish economy. These include, as already noted by many Directors, a reduced personal tax burden and reduced incentives for investments in capital-intensive production. Furthermore, there seems to be no room for real wage increases, and rigidities in the labor market--as evidenced by the existence of an "outsider" labor market--should be actively dismantled. A successful implementation of policies in these areas will no doubt prove crucial in improving the competitive position of the Irish economy.

We note that the Irish authorities are committed to a stable exchange rate in pursuing their economic adjustment policies, particularly in view of past experience of adverse effects on the domestic economy following a depreciation of the exchange rate.

We have great sympathy for this line of reasoning, as the same kind of arguments frequently have been put forward in economic policy considerations in the Nordic countries. If, however, the policies now put in place by the Government fail to restore balanced growth over the medium term, exchange rate adjustments might prove necessary, especially given that Irish competitiveness with respect to its main trading partner, the United Kingdom, has deteriorated substantially over the past few years.

As stated by the staff, income moderation is now of paramount importance for revitalizing the Irish economy. The Government has started a dialogue with the social partners, and we hope there will be a growing understanding among them concerning the importance of the adjustment measures already implemented and a necessary enforcement of such policies.

Mr. Posthumus, remarking briefly on the budget deficit, noted that at the present level of official debt, an increase by 1 percentage point in the average rate of interest on debt which the Government had to pay would require a decrease of real noninterest expenditure of 7 percent, if an increase of the borrowing requirement was to be prevented. Those figures illustrated the seriousness of the debt situation.

He agreed with those who had noted that the tax base in Ireland was rather narrow and that taxes fell disproportionately on wage earners, Mr. Posthumus commented. Broadening the tax base in favor of wage earners might be instrumental in a policy of wage moderation; he believed there was room for such a broadening because taxation in Ireland, in comparison with that in other European countries, was quite low.

Finally, on the competitive position, Mr. Posthumus indicated that he could fully support the staff's observations regarding the exchange rate policy. Depreciation could not really improve Ireland's competitive position; that task could be done best through a moderation of costs, and he agreed with the authorities' use of monetary policy to support exchange rate policy in the framework of the European Monetary System (EMS), which sometimes meant that rather high interest rates had to be accepted.

Mr. Zecchini made the following statement:

The process of adjustment of Ireland's major macroeconomic imbalances came to a standstill in 1986, in spite of a favorable terms of trade evolution. Besides some positive results in inflation and the current account, no progress was achieved in the reduction of the budget deficit; moreover, the stock of government debt continued to rise relative to GNP, and unemployment increased.

Definitely, exogenous developments have contributed to the disappointing performance; however, some failures in implementing the fiscal strategy and slippages in wage policies were also responsible for the standstill in the adjustment process.

Prospects for 1988 look somewhat better, as indicated in Mr. McCormack's informative opening statement. Hence, the authorities should not fail to take advantage of this favorable outlook and address with determination the key imbalances in the fiscal field and in wage dynamics, in order to improve and strengthen economic performance in the coming years. Since we broadly share the staff appraisal, we will comment only briefly on demand policies, competitiveness and structural issues.

On fiscal policies, we welcome the commitment of the new Government to reduce the budget deficit. The targets set for 1987 are significant and the correction is appropriately based on expenditure reductions rather than on revenue raising. Moreover, we agree with the authorities' medium-term objective of bringing to a halt the rise in the debt to GNP ratio. This is a necessary first step in the process of reducing the overall size of the debt. Again the correction should come mostly via reduction of current expenditures, and, to this end, priority should be given to containing the growth in public sector wages. In contrast, further cuts in public investment programs as suggested in the staff paper should be avoided. Total capital expenditures, which are only one fifth of current expenditures, have been declining in nominal terms since 1984, and so has the capital budget deficit. Moreover, further reductions in public capital expenditure will add to the already bleak performance of fixed investment, which continued to decline in 1986 for the fifth year in a row and which eventually may have a strong negative impact on prospects for growth and employment.

Monetary policy in 1986 was appropriately managed so as to stabilize the exchange rate of the Irish pound. The exchange rate strategy, which consisted of a mix of interest rate measures and exchange market interventions, was successful in maintaining the Irish pound stable within the EMS and in countering speculative capital flows. It was, however, costly in terms of the effects of increases in interest rates on domestic activity and on the interest rate component of the budget expenditures. In order to reduce such costs, the authorities, in the future, might consider a more extensive financing of market intervention through the EMS Very Short-Term Financing Facility. We understand that that facility has been utilized only on limited occasions, and for limited amounts, mainly because of the unwillingness of the authorities to let the pound fall to the lower intervention margin. In view of the amounts that can be mobilized, the terms of financing, and the symmetric monetary base effects that such type of financing exerts on both the currencies in opposition, the usefulness of such a mechanism should not be underestimated. Of course, we are referring to this instrument exclusively in the case of very temporary disturbances in the markets and are not suggesting that it be used to counter fundamental changes in market attitudes.

The authorities should also consider expanding the secondary market for government securities. At present this market is very thin. Increasing its depth and resilience will allow accommodation of inflows or outflows of capital with more limited movements of interest rates on government debt.

As for exchange rate policy, the authorities' commitment to stabilize the effective exchange rate in order to control inflation seems appropriate. We wish to emphasize, however, that such a commitment in the coming years will require a significant reduction of Ireland's wage dynamics relative to its trading partners in order to improve competitiveness. In the recent past, the relative increase in hourly wages has been more than compensated by relative gains in productivity: as a result, external competitiveness has improved. It is unlikely, in our opinion, that the same improvements in relative productivity can be maintained in the coming years, first, because of the weak investment performance in recent years and the high level of unemployment in Ireland, and, second, because in other competing economies, especially the European ones, productivity is also likely to increase.

Therefore, a reduction of relative wage dynamics, framed within a broader set of incomes policy measures, can play a crucial role in improving competitiveness and export performance. In this respect, we welcome the recent discussions between the Government and the social partners on a program for achieving, inter alia, pay moderation and wage flexibility.

In the area of structural reform, priority should be given to a review of the tax system. In order to alleviate the adverse effects that taxation is having on job creation, the objective should be to eliminate distortions caused by tax exemptions and allowances and to reduce the tax burden on employed people, since this hampers wage restraint.

We also welcome the authorities' initiatives to reduce unemployment through microeconomic measures aimed at strengthening the incentives to work and at favoring employment of long-term unemployed workers.

To conclude, let me add that this year's consultation with Ireland offers a clear example of the serious problems and the high costs that coping with exchange rate instability generated by exogenous factors can cause in a small, open economy. There is no doubt that the country will greatly benefit from a more stable exchange rate environment in the world at large and not solely in the European Community.

The staff representative from the European Department agreed with Mr. Prader that improved competitiveness had been an important factor in the better export performance of the Irish economy in the first half of 1987. However, other factors had played a role as well: the strong growth of the U.K. market, which remained Ireland's most important market; some recovery in exports to the oil exporting countries; and continued expansion in capacity, particularly in the electronics sector.

On fiscal policy, the staff representative observed that discussions between the Government and the social partners on a number of issues were continuing. While there was as yet no clear indication of when the discussions would be concluded, broad agreement appeared to have been reached on the main elements of the national recovery program. It was accepted that the program would have to address questions related to expenditure policy, not only for 1988 but over the medium term. The question of tax reform was also prominent on the agenda of the discussions, and there was agreement that the tax system had to be modified.

Several Directors had commented in their remarks on the need for "frontloading" the adjustment effort, a point well appreciated by the authorities, the staff representative continued. The main elements of expenditure that would have to bear the burden of adjustment had been identified, with much technical work having been done both in the Department of Finance and by advisory bodies like the National Economic and Social Council. Transfer payments were an important area in that respect, given their rapid growth in recent years.

On public investment, substantial retrenchment had already taken place, the staff representative said. Most of it reflected the winding down of some major projects that had been undertaken in the late 1970s and early 1980s in the telecommunications areas and the energy sector. One component of the public investment program that had not so far been significantly affected by efforts to improve the public finances was the social infrastructure, an area that should perhaps receive more attention. Privatization was also envisaged, albeit on a limited scale. The main difficulty was that most of the public enterprises were not in a sufficiently strong financial position to make privatization a realistic option at present.

It was widely recognized that tax reform was necessary, the staff representative commented. However, the authorities were of the view that some of the proposals made in the recent past had been too radical. For example, the introduction of a single rate of income tax coupled with a progressive tax on expenditure had been proposed but this was considered impractical in present conditions, particularly given the paramount importance attached to ensuring that any tax changes were revenue neutral. Nonetheless, the authorities and the staff agreed that there was room for less ambitious changes in the tax system. In that connection, Mr. Foot had referred to the taxation of farmers. Several attempts had been made over the years to bring the farmers more effectively under the tax net. As of the present year, farmers were subject to the same income tax as all other taxpayers, although consideration was given to the possibility of reducing some of the tax relief measures that farmers still enjoyed. In particular, the suggestion had been raised that the social security tax might be expanded to cover self-employed people, including farmers, as of 1988.

The taxation of short-term social security benefits was another area to which consideration should be given, the staff representative noted. It remained desirable, in his view, to bring those benefits into the tax net, not only to enlarge the scope for reductions in other rates but, more important, to avoid the adverse implications that not taxing such benefits could have for the evolution of replacement ratios over time.

Remarking on labor market rigidities, the staff representative observed that the tax wedge (i.e., the difference between gross wages and take-home pay) and, more specifically, the increase in the wedge over the recent past was probably the most serious impediment to the smooth functioning of the labor market. It was interesting to note that although gross wages had not apparently responded to the increase in unemployment, the picture changed substantially when the focus shifted to net of taxes wages, where there had been a decline on the order of 10-15 percent in real terms during the 1980s. Given that development, it was perhaps less surprising that gross wages had not shown greater responsiveness to the rise in unemployment.

On the implications for Ireland of the full incorporation of the pound sterling in the EMS, the staff representative remarked that one of the main advantages would be a reduction in exchange rate uncertainty which should lower the volatility of capital flows. The expectation was that interest rates would decline in such an eventuality. On intervention policy, as Mr. Zecchini had observed, Ireland had made only limited use of the short-term financing mechanisms available within the EMS. Like the authorities in other countries, the Irish authorities undertook most of the intervention within the margins of the intervention points.

The changes in industrial policy introduced in 1984 were mainly changes of emphasis, the staff representative said. The authorities regularly reviewed industrial policy, and the first review had been published earlier in 1987. The conclusion drawn from the review was that, so far, the benefits of the reorientation of industrial policy had been fairly limited. In the circumstances, the authorities were considering further means of enhancing the effectiveness of the policy. In particular, they were giving attention to the idea of linking the amount of capital grants more closely to the contributions new projects could make to employment. In addition, an effort was being made to improve coordination between the various government agencies involved in the implementation of industrial policy.

Mr. McCormack observed that most of his colleagues had stressed the urgency of pursuing fiscal retrenchment in Ireland. His authorities were committed to reducing the debt/GNP ratio as soon as possible, although they had not yet established a precise timetable for doing so. What they were attempting to do was to generate a sense of momentum by taking measures as soon as possible. For example, they were already reviewing expenditure cuts in 1988 and, as the need for or desirability of introducing specific cuts became apparent, they were being effected, even within the current year. Indeed, only a few days previously, the authorities had effected very large reductions in spending. Virtually every week the authorities were introducing what in other years would have been considered a minibudget; and he believed their recent record of action was an indication of the seriousness with which the authorities were viewing the need to reduce expenditure.

It might be useful for his colleagues to know that on September 2, the leader of the main opposition party had committed himself and his party unequivocally to supporting the Government to the extent that the declared policies were in fact pursued, Mr. McCormack continued. That commitment had strengthened the authorities' hands considerably and was, in many respects, an unparalleled event in Irish political history.

As he had noted earlier, his Irish authorities recognized the need for tax reform but believed that some of the proposals that had come out of the review of the tax system by the Commission on Taxation were too radical to implement at present, Mr. McCormack said. The Irish authorities were concerned about committing themselves to a tax reform that could easily be translated into tax reductions; this could undo their efforts at fiscal retrenchment. Their fear was that it might be difficult at present to effect a genuinely revenue neutral tax reform.

Discussions with the social partners in Ireland were continuing, Mr. McCormack noted. Little concrete detail had emerged from the discussions thus far, in part because, given the seriousness of the issues, no one wanted to rush into developing a medium-term program that could quickly become discredited. Recent experience with programs in Ireland had not been happy. As pointed out in the staff report, the targets of the previous program had become rapidly outdated, which had discredited the exercise. The authorities on the present occasion were thus concentrating on specific measures and had not yet committed themselves to a firm date for publication of a program.

In conclusion, Mr. McCormack indicated that his authorities welcomed the staff's proposal to place Ireland on a bicyclic consultation schedule, especially given the severe pressure on resources in the Department of Finance and in the Central Bank. On the other hand, they did not want to weaken the effective surveillance of the Irish economy in any way and would continue to cooperate with the Fund staff to ensure that that did not happen.

The Chairman made the following summing up:

Notwithstanding the commendable further progress that had been made in 1986 in lowering the rate of inflation and the external current account deficit, Executive Directors noted with concern that economic activity in Ireland had stagnated, investment had declined, and the unemployment rate had continued to increase. They stressed that these unfavorable developments reflected to a large extent the persistence of large fiscal imbalances and structural weaknesses.

Directors expressed particular concern about the precarious situation of the public finances, which they viewed as the prime cause of the country's economic difficulties. They noted that as a result of persistent and sizable budgetary deficits, the government debt and the consequent burden on the budget of its servicing, had risen to a particularly high level. Directors therefore welcomed the renewed determination of the authorities to reduce the fiscal imbalances. Some Directors observed, however, that while the fiscal objectives set for 1987 represented a significant adjustment effort, they were nonetheless modest if viewed against the magnitude of the problem.

The emphasis on cuts in current expenditures was regarded as appropriate, but unless action in that regard was strong and persistent, it may need to be complemented by measures to enlarge the tax base if the fiscal situation was to be brought under control. Directors urged more frontloading in the fiscal correction and underscored the importance of avoiding slippages in the implementation of the 1987 budget. The authorities should, they said, give the highest priority to achieving a further large reduction in the Exchequer borrowing requirement (EBR) in 1988 and beyond. A program of fiscal adjustment over the medium term, developed in collaboration with the social partners, would gain in credibility if it incorporated a comprehensive review of the role of the public sector.

Directors agreed with the authorities that an improvement in Ireland's economic growth performance was also needed in order to alleviate the unemployment problem, particularly youth unemployment, and to assist in the correction of the fiscal imbalances. Directors emphasized that the success of such an effort would depend crucially on a substantial strengthening of the competitive position of the Irish economy but also on major reforms of the tax and benefit systems.

While the preservation of the present system of decentralized pay bargaining was desirable, Directors said, they were concerned that, notwithstanding the high level of unemployment, average earnings had continued to rise considerably faster than consumer prices. Determined wage restraint was thus of the essence, and public sector pay policy should set the example. Directors also urged the authorities to press ahead with a restructuring of the tax system in order to ease the tax burden on wage earners and enhance the prospects for pay moderation and job creation and they encouraged the authorities to take further steps to improve the functioning of the labor market.

Directors noted the authorities' commitment to an exchange rate policy that did not accommodate excessive cost pressures. They stressed, however, that the success of such a policy was predicated upon tight financial policies and wage restraint in order to safeguard the external position while also reducing the disturbingly high level of unemployment. Moreover, a few speakers commented that an element of flexibility in the management of the exchange rate within the EMS remained desirable given the importance for Ireland of developments in the value of the pound sterling and the U.S. dollar.

Directors viewed with serious concern the continued large recourse to external borrowing by the Exchequer, which had led to a further increase in Ireland's exceptionally high external debt to GNP ratio.

Some Directors questioned the overall effectiveness of Ireland's industrial policy, noting that its contribution to employment had been limited while its cost to the budget had been high. They stressed that a reduction of tax concessions associated with that policy could help restore a better balance between capital and labor costs, while contributing to a broadening of the tax base.

Directors noted that Ireland had been placed on the "bicyclic" consultation procedure, but it was observed that whether or not a full Article IV consultation on the standard cycle might be in order would depend on Ireland's economic performance.

2. FINANCING FOR COUNTRIES WITH PAYMENTS DIFFICULTIES; INTERNATIONAL CAPITAL MARKETS AND OFFICIALLY SUPPORTED EXPORT CREDITS - DEVELOPMENTS AND PROSPECTS

The Executive Directors considered staff papers on recent experience with, and possible adaptations of, financing for countries with payments difficulties (SM/87/190, 7/31/87) and on developments and prospects in international capital markets (SM/87/194, 8/5/87), and in the use of officially supported export credits (SM/87/195, 8/5/87; and Cor. 1, 8/13/87). They also had before them papers on capital market financing for developing countries (SM/87/207, 8/17/87) and on international banking activity in the first quarter of 1987 (SM/87/209, 8/12/87).

Mr. Abdallah made the following statement:

From the set of papers that is being discussed today, two main facts emerge: first, developing countries obtained no net financing in international bank and bond markets in 1986, and, second, there was an acceleration in lending to industrial countries. Both developments are cause for concern. The first indicates that developing countries, and, more especially, the debtor countries, are not getting adequate funds to support their growth-oriented adjustment programs. The second is a reflection of policies being followed in some industrial countries where deficits are increasing. By virtue of the size and strength of their economy, these industrial countries are attracting scarce resources which could have been made available to developing countries.

On developments in the international capital markets, we continue to be very concerned at the slowdown in capital flows to developing countries. As the staff paper indicates, developing countries as a whole made net repayments to commercial financial institutions in 1986. Many of these countries, especially those with severe debt-servicing problems, are pursuing strong growth-oriented adjustment programs that need to be supported with significant financial resources. The inadequacy of flows of such capital can only adversely affect the success of these programs. For those countries able to receive additional capital inflows from commercial banks, I note that there have been in many cases a hardening of conditions. This is all the more worrisome because such a stance indicates that debtor countries are made to bear an inordinate proportion of the debt burden. Commercial banks are still not carrying their fair share of the debt burden.

I note, however, that some banks have begun to show a greater awareness of the difficult financial position of developing countries and are coming up with more imaginative approaches to the debt problem. While these innovations can give the countries a breathing spell in the immediate future, the burden associated with the servicing of the debt in the longer run is increased. This can lead to severe problems if there is a worsening in the international economic situation.

As it appears from the papers, the prospects for more normal lending are not encouraging. Among the reasons given by bankers is the uncertainty about future developments in the interest rate and exchange rate markets. This uncertainty is related to the large imbalances in the internal and external positions of some industrial countries. Until those imbalances are reduced, the availability of financial resources to support the adjustment efforts of the developing countries will continue to be inadequate.

In the paper on financing for countries with payments difficulties, reference is made to the necessity for debtor countries to follow strong adjustment programs in order to restore creditworthiness. Over the past few years, most of these countries have been implementing adjustment programs with Fund financial support, and yet adequate financing from commercial banks has not been forthcoming. This reinforces my authorities' view that adjustment efforts alone are not sufficient to establish creditworthiness. Perhaps the most important factor is the prospect for increasing export receipts. While many of these countries have taken strong steps to increase exports, factors beyond their control have adversely affected their efforts. These include low growth in industrial countries, low commodity export prices, and uncertainty in the financial markets, developments which again indicate that a successful adjustment process that can lead to sustainable growth and improve the ability to repay debts depends, to a large extent, on industrial countries' policies. The implementation of appropriate policies in industrial countries is, therefore, also a necessary ingredient in the effort to solve the debt problem.

Among new types of financing options, one possibility is for multilateral development banks and other financial institutions to increase the amount of their financial assistance to debtor countries and to make them available on highly concessional terms. In that respect, the efforts to triple the amounts of SAF resources are in the right direction. Furthermore, as the staff mentions, some type of debt relief will need to be considered for many countries, especially for those in Africa, since the rescheduling of their debts, as is done now through the Paris Club, can only postpone the problem.

On the subject of officially supported export credits, I welcome the fact that export credit agencies have been adopting a more positive stance. But I cannot fail to notice that the volume of new market credit and cover commitments to developing countries have continued to fall over the past two years. One reason is that many countries with payments problems have reduced the number of investment projects. While in certain measure this may indicate an effort to improve efficiency, it also indicates that the efforts to reduce imbalances are being made at the expense of investment, because external financing has been inadequate. Continued reduction in the investment budget can only lead to a lowering of future economic growth, with all its adverse consequences. I would, therefore, urge the authorities in those countries to adopt a more flexible approach with respect to export credit.

Finally, on the inadequacy of presently available statistics on officially supported export credits, I support the staff call for governments to cooperate fully with the efforts now under way in the OECD and the Berne Union to effect improvements.

Mr. Hubloue made the following statement:

It is not an easy task to select from the extensive menu of well-documented topics raised in the staff paper those which seem most relevant to today's discussion. I have somewhat arbitrarily chosen to confine my comments to the situation of the middle-income debtors, since the financial developments with respect to the low-income countries and the industrial countries will again be taken up in the coming days or months. Unfortunately, this choice seems additionally dictated by the persistence and even aggravation of a thoroughly splintered capital market: net international lending between the industrial countries peaked at $600 billion in 1986, but net lending to developing countries came to a halt. The latter outcome is the net result of another market split, with countries free of debt problems able to borrow $10 billion while troubled debtor countries were forced to make net repayments of a comparable amount. Further disaggregation would reveal still another source of differential treatment, between the few countries which are considered a systemic risk and many others which are now generally expected to be excluded from any major market borrowing for many years. These are worrisome trends, which should be kept in mind when singing the praises of the globalization of the international financial markets.

Three areas of controversy seem especially ripe for the Fund's guidance on the debt strategy for the middle-income debtors: debt redemption versus debt accumulation; general purpose lending versus specific purpose lending; and private versus official lending. The recent report of the Board of Directors of the Institute of International Finance presents outspoken views on each of these issues, views to which I shall refer during the remainder of my comments.

The doubts which have arisen about the legitimization of additional debt creation in the form of new lending are not surprising when we look at the recent evolution of countries' debt ratios. Although two years ago the staff still had good reason to expect that the debt to export ratio of the problem debtors would by now have declined from 250 percent of exports to 230 percent, that ratio has instead shot up to 310 percent, while debt service ratios have continued to rise to over 40 percent instead of stabilizing around 35 percent. The failure of these early projections to materialize certainly does not reflect an overoptimistic view concerning the willingness of indebted countries to adjust, nor does it reflect any overlending which might have taken place during the period. On the contrary, this unpredicted outcome is explained by two other factors. First, the massive rescheduling operations concluded in 1983, mainly for short-term periods, produced a repayments hump which, as we foresaw at the time, is now raising debt-servicing levels and suggests that a second round of negotations--we hope for longer periods--must be accepted as a necessary step in the continuation of the debt strategy. Second, many countries have seen their debt-servicing capacity severely eroded by export shortfalls due to the slowdown of world demand and the collapse of world commodity markets, a situation which has not only damaged their external situation but has also generally delayed their progress on the structural reform of their economies.

In the light of these worrisome outcomes, the banks have decided that it would be unwise to add new debt to these countries' ever growing debt burdens until such time as world demand conditions improve sufficiently for existing debt levels to be reabsorbed through higher exports. Because of the extensive provisioning of recent years, they no longer see a need to protect the servicing of outstanding claims by the creation of new claims, and they propose instead that excessive debt levels must be reduced until the value of old debts is restored. The incorporation of debt/equity schemes, buy-back arrangements and exit bonds into new rescheduling agreements is a relatively mild manifestation of this basic attitude, which is more adversely reflected in the negative lending trend of the last two years.

It is clear that debt conversion schemes have a certain appeal. The staff and the banks agree that they introduce a welcome element of flexibility, softening the rigor of traditional concerted lending practices; that they provide an answer to the divergent interests of the creditor banks; and that they afford an orderly, market-related alternative to the disruptive outcomes which would follow debt repudiation or a generalized scaling back of the banks' involvement in the debt strategy. However, these approaches must be considered with caveats against misinterpretation.

The substitution of debt reduction or debt conversion for debt accumulation may be based on a view of the further course of the debt strategy which is skewed by persistent large discounts in the secondary markets. The implications which these discounts have for the assessment of a country's debt-servicing capacity were debated during our previous discussion on the debt strategy. The staff reports now in hand seem to bear out the view that these market quotations can hardly be considered to represent the real value or any given debt; they rather seem to represent the absence of a market, since no price has been found low enough to bring about the entry of any potential demand. Secondary market considerations alone, then, do not provide a case for reducing, rather than servicing, existing levels of indebtedness.

More fundamentally, the preference for debt conversion over debt accumulation may be based on a false perception of the debt problems: the requirements of the international adjustment process call for the servicing, not the repayment, of developing country debt. The basic problem to be addressed by the present strategy is the insufficiency of export growth to service interest on outstanding debt. Debt reduction schemes have only an indirect and marginal impact on the level of interest to be paid and cannot close the present gap between the rates of the debtors' export growth and their interest burdens. The only durable way to resolve the debt problem, then, is to reaffirm the principles of the present strategy: export levels must be increased through structural adjustment and higher world demand, and until these produce their expected effects, new lending combined with longer grace periods will be needed to close the recurrent gaps between inadequate export growth and high interest burdens. Debt conversion is an attractive complement to these basic tactics but cannot replace them as basic prescriptions of the present strategy.

The impact on the present strategy of replacing specific purpose lending by general purpose lending is a second, related controversy. I was struck by the bankers' principled unwillingness to take part in any further balance of payments financing and by their proposal that, from now on, trade and investment financing should replace general lending operations as the sole basis for establishing future debtor-creditor relationships. Why is it that the function of general current account lending, which was so generously carried on throughout the 1970s and is still going strong in the case of the industrial countries, has suddenly disappeared as an essential component of the functioning of the international financial markets as far as the developing world is concerned? A similar question has to do with the basic incompatibility which the IIF report has discovered between the role of the commercial banks and their participation in commodity price contingencies along the lines of the Mexican program. This chair has for years suggested, and we still believe, that such schemes could considerably improve the resistance of the present strategy to external shocks, while being fully consistent with the function of the international capital markets, namely, the smoothing of countries' orderly adaptation to changing circumstances. I am afraid that until this basic notion concerning the role of the banks in the international adjustment process can be clarified, the present strategy will go on being frustrated, and the restoration of market access will be fundamentally delayed.

This is not to deny the basically positive contribution which increased investment financing can and should make as an essential component in the continuation of the debt strategy: general purpose lending has, in the past, been overloaded, with the implied consent of both debtors and creditors, who have preferred to link their lending operations to official government guarantees instead of subjecting them to the risk that the investments which the lending proceeds would ultimately finance might turn out not to perform. This dislocation must be corrected. Future investment funds should be promoted on the basis of investment programs submitted by the borrower in conformity with the country's general restructuring objectives.

Let me make a few concluding observations on the controversy between official and private lending, which is extensively debated in banking circles. As they insist that they will press for ever larger contributions from official creditors, the banks should keep in mind that in the last five years, the share of official creditors in the total debt of the problem countries has already climbed from 24 percent to 37 percent. This restoration of historical patterns is not solely due to a scaling back of the commercial banks' involvement. It also reflects the constructive approaches which official lenders have, one after another, already adopted vis-à-vis their roles in the debt strategy. The community of export credit agencies, by its excellent performance, stands out among the group of official creditors as never having failed to explore avenues for supporting the restoration of normal business relationships. This group is now in a position to reopen medium- and long-term cover policies, even to such an extent that the ceilings are largely underutilized for lack of sufficient import demand.

An area of direct concern to this Board is the negative lending trend which now affects the Fund's financial involvement in the debt strategy, a development which is regarded askance by both the banks and the debtors. It has been suggested that this negative lending trend has to be acepted as an inevitable consequence of the Fund's prolonged involvement in the debt strategy. Overreliance on demand-management policies is cited as the reason adjustment still takes so long to bear fruit, and as the reason the Fund's resources have been immobilized for excessively long periods. Reinforcement of structural reform policies yielding rapid balance of payments effects is therefore put forth as a solution for restoring the Fund's financial flexibility in the adjustment process.

While I fully support these proposals, and the plea for structural reform they represent, I would also propose that we reflect on their implications for the size of Fund lending, and I suggest that the success of this desirable reorientation of adjustment policies does in fact critically depend on a substantial enlargement of Fund resources to support the much heavier initial costs of structurally oriented adjustment. Application of this thinking to the Fund's quota size five years ago would have implied agreement on a much larger quota increase then. Since that did not occur, we will from now on have to consider the even greater need for a substantial increase on the occasion of the Ninth General Review of Quotas.

In conclusion, recent innovations in the restructuring process add an important element of flexibility to the present debt strategy, which is even more justified, given the medium-term context in which this strategy has to be continued. However, we should strongly resist the temptation to consider these innovations a valid substitute for additional financing flows, the need for which is ever present and to which the continuation of structural adjustment in the debtor countries is inseparably linked. This function has so far been rather successfully shared between official lenders and the commercial banks. The fact that this partnership has allowed the banks to establish large loan loss provisions should not now be accepted as a valid justification for fundamentally revising the cooperative spirit on which the strategy was initially based. Given the unclarified views which seem to be held in banking circles on these basic aspects of the debt strategy, I would suggest that the Managing Director transmit the summing up of this discussion to the Chairman of the IIF as part of our ongoing dialogue.

Mr. Grosche made the following statement:

In discussing financing for debt-ridden countries, it is important to differentiate between those which are mostly indebted to official creditors and those mainly indebted to banks. I will concentrate on the latter.

In order to develop fully their large growth potential, middle-income countries have to re-establish a satisfactory domestic savings and investment balance, including a reversal of capital flight. The staff is right in stressing this point. Whatever the need for additional foreign financing after such measures, it seems obvious that it can never be satisfied by official flows, which are limited and should be reserved mainly for the poorest countries in this world. It is, therefore, in the clear interest of middle-income countries to adhere to the overriding objective of the current debt strategy, which is to restore normal debtor/creditor relations in due course.

This objective is taking longer to reach than expected. Nonetheless, I fully share the staff's view that the strategy of looking for cooperative solutions tailored to each individual case remains correct. In this strategy, all participants must play their respective roles effectively: first, the debtor countries have to design and implement in a steady fashion adjustment policies that create the conditions for higher growth, if necessary with Fund assistance; second, the banks have to agree to rescheduling arrangements and to imaginative solutions for a reduction of the interest burden and/or for fresh money; third, the industrial countries have to strive for open markets and low interest rates; and, finally, the World Bank and other development banks must provide additional financing for structural adjustment.

These elements have not always or in all cases been in place. Therefore, we have seen and are still witnessing problems--indeed, serious problems in a few cases. But, overall, the strategy has proven to be effective. In contrast to what had to be dealt with in 1982/83, we do not have to face a systemic crisis anymore. Very difficult cases have been resolved: only recently, for example, new packages for Mexico and Argentina have been put together, and new, imaginative features have been added.

All parties must now continue on this road and must be open-minded with regard to further adaptations. The solution clearly cannot be found on a global plane but--on the contrary--only in deepening the individual, case-by-case approach.

What is the role of the Fund in this strategy? Certainly, it is not to interfere with the negotiations between banks and debtor countries and, particularly, not to take over responsibilities and financial obligations from both parties. The Fund basically has to pursue its catalytic role. In this context, the Fund should continue to demonstrate to both parties the value of taking a longer perspective. Banks should not push for maximum yields now, choking customers of the future. And debtors, in moving to reduce or to postpone interest payments, have to balance this action against the need for not steadily weakening the value of existing obligations, thereby blocking the access road to the credit markets of the future.

Clearly, it is of paramount importance that both parties make every effort to arrive at mutually agreed solutions in a cooperative manner. Forced solutions will benefit no one, as they will close rather than open the door to normal debtor/creditor relations.

Turning to the second general question raised in the staff paper, I agree that additional borrowing must be serviceable in the medium term, which means that the appropriateness of additional borrowing depends, first and foremost, on how the funds are used in each case. If effective policies are pursued to improve the quality of a country's capital stock, to diversify production and enter into highly competitive markets while at the same time establishing a sound macroeconomic environment, an increase in the level of indebtedness could be efficiently absorbed by the debtor country without causing additional debt-servicing problems. Not surprisingly, following such policies also holds the best promise of re-establishing spontaneous access to international capital markets. Nevertheless, it seems obvious that the existing debt burden--coupled with the difficulty of subordinating old debt to new in the case of sovereign borrowers--limits the scope for further borrowing.

Therefore, seeking solutions for a reduction of the burden, market-oriented solutions rather than government compulsion of cartels of debtors or creditors will prove to be the most successful. Banks and debtors together must be interested in the establishment of a broad secondary market. Without such a market, I am afraid, not enough new money will come forward. Fortunately, some of the innovations introduced in recent packages point in this direction and should be explored further. The growth of an active secondary market in Third World debt should also stimulate the creation of a primary bond market that will raise more money from nonbanking investors.

The authorities in creditor countries can do their part to assist in this process of developing new mechanisms and diversifying lending options by ensuring that their regulatory and supervisory framework provides banks with the necessary flexibility. In a number of creditor countries much has been done already, sometimes at considerable cost to taxpayers. I would be interested in further comments the staff may have on the possibilities--and attempts perhaps already under way--for increasing convergence in regulatory and tax provisions for banks in different creditor countries. Such a harmonization could further enhance the process of finding innovative solutions and, as the staff points out, could better ensure that lending flows and modalities reflect economic rather than tax or accounting considerations.

As far as the third question is concerned, I have little to add to the staff's assessment. The increasing use of the "menu" approach is certainly a welcome development in recent financing packages, as it provides banks with a broader set of options, thus responding better to their different interests. I would also agree that interest capitalization--if arrived at on a negotiated basis--could on a limited scale provide additional flexibility. But because of its various shortcomings, more generalized interest capitalization is unlikely to feature prominently in financing packages.

It could, however, be brought to good use in the context of the fourth issue raised by the staff. It would, indeed, be desirable if more comprehensive and workable solutions could be found to hedge against interest and exchange rate risks in restructuring agreements in order to reduce debtor countries' vulnerability to adverse developments, which are usually beyond their control. In addition to interest rate swaps and other options, the capitalization of an additional interest burden should be further explored.

Finally, regarding the role of official funding, I think my opening remarks have made clear that while there is no denying that official creditors and multilateral institutions have an important role to play, financing from these sources can and should be considered only as complementary to and not as a substitute for private sector funding.

My authorities will continue to play their part in assisting developing countries in their efforts to overcome economic and financial problems, both bilaterally and in the context of the Paris Club, the Fund, the World Bank, and other multilateral development banks. Special efforts have been made with regard to the poorest countries, either through the Special Facility for Sub-Saharan Africa, in the context of IDA-8, or in the conversion of official development loans into grants for the 24 poorest developing countries. My authorities support a capital increase for the World Bank and are actively involved in the latest quota review, with the aim to ensuring that these institutions have sufficient funds to carry out their responsibilities.

We have together with our G-7 partners welcomed the Managing Director's structural adjustment facility initiative and hope that an agreeable solution can be found.

Before concluding, let me offer a suggestion of a more procedural nature. Since today's discussion is centered mainly around the debt problems of developing countries, we obviously cannot do justice to the various other aspects raised in the excellent papers on international capital markets insofar as they relate to developments within or between industrial countries' lending operations. While I shall take up a number of points of a more technical nature bilaterally with the staff, I would consider it helpful to have these papers made available as background material to our forthcoming discussions on "Innovations and Institutional Change in Financial Markets"; perhaps we should wait on the publication of these papers until we have had a chance to look at them again in more detail. Then they could be revised before publication.

Mr. Ortiz made the following statement:

To the dismay of some of the participants in the debt strategy, the debt problem will not, like a headache, go away if left unattended for sufficient time. Half a decade of muddling through, on the basis of stern adjustment by debtor countries and mostly insufficient and inadequate financial solutions, has produced a heavy toll in debtor countries with drastically deteriorated living standards and impaired growth prospects. It has also produced a sense of frustration and acrimony, in view of the increased economic vulnerability of debtor countries and the reduced margins for political action.

Despite the perennially optimistic predictions of the creditor community--supported by the overly optimistic assessments of the prospects for the world economy produced by the Fund--most debtor countries have not restored adequate growth prospects after years of debt servicing and budget austerity. Nor are they any closer now than at the outbreak of the debt crisis to regaining creditworthiness. The current debt strategy has thus failed in the fundamental sense that it has not yet achieved its main objectives which, as the papers prepared for this discussion duly recognize, are not yet within reach.

In a way, the debt situation is being gradually resolved by the force of circumstances. While it is true, as the main paper (EBS/87/190) states on page 4 that "the basic approach that has been confirmed is that debtor countries have continued to eschew sovereign defaults in recognition of the consequent economic dislocation...," at last count, there were more than two dozen countries which had unilaterally suspended some or all debt servicing; this list includes about one third of the countries belonging to the group of the 15 most heavily indebted. It is clear that the debt strategy has failed because of the three premises on which it was based--(i) strong adjustment on the part of debtor countries; (ii) a favorable external environment; and (iii) adequate finance--only adjustment has taken place.

The debt strategy would have had a much greater chance of succeeding if the external environment had been more favorable. This, however, has not been the case. The story is a familiar one: insufficient growth in the industrial countries, high real interest rates, and a drastic deterioration of the terms of trade, brought about by declining commodity prices. The indicator most commonly utilized to assess the payment capacity of indebted countries--itself a factor in determining creditworthiness--has deteriorated rather than improved since 1982. The debt/export ratios of the 15 largest debtors and of the group of low-income countries have increased 27 percent and 33 percent, respectively, from 1982 to 1986, although some improvement is expected for 1987. In contrast, according to the latest figures provided by the World Economic Outlook, the debt/GDP ratios for both groups of countries are expected to deteriorate further in 1987. We are thus facing the paradoxical situation of countries generating large trade surpluses to service their debts, while at the same time becoming more insolvent from a balance sheet perspective.

On the matter of financing, both the figures and the analysis contained in the paper on capital markets are more than eloquent. Total international lending to developing countries actually declined in 1986; even if new money commitments for 1987 are considered, the total amount of finance channeled to indebted countries has been much lower than the rather modest amounts envisaged under the Baker initiative.

To put it simply, banks are unwilling to lend further to most indebted countries. The very limited lending envisaged will be confined, in the view of the banks, to a few countries and for specific purposes, such as trade finance and project cofinancing. One important reason why banks are seeking to reduce their exposure in indebted countries, and thus to improve the "quality" of their balance sheets, is that they face intense competition in the international capital markets. Credit exposure to debtor countries affects the price at which banks can raise capital and other resources, impairing their ability to compete with unexposed banks and other financial intermediaries, thus endangering their relative position. Since competition is likely to increase rather than diminish in a general environment of financial liberalization, the prospects for a return to voluntary lending for the vast majority of indebted countries are not likely to improve.

I must say that the paper on financing for countries with payments difficulties leaves no false illusions regarding the possibilities for indebted countries to regain creditworthiness in the foreseeable future. It also presents a realistic assessment of the current situation, a useful review of the adaptations and modifications of financing techniques, raising a number of important questions. It seems clear that a number of these "adaptations" stem not only from the "desire on the part of both debtors and creditors to introduce a greater degree of flexibility in the process and to speed the assembly of financing from banks in support of essential policy reforms" as stated in the paper, but are also the outcome of an intense process of confrontation and compromise on the part of both groups. This process reflects, on the one hand, the desire of creditors--particularly commercial banks--to reduce their exposure and shift the burden of finance to third parties, and the realization on the part of debtors that, despite the maintenance of debt service and the costs incurred in adjustment, their economic prospects were not improving. It is no secret that some of the innovative features of the Mexican package were obtained after lengthy and tense negotiations and the prospect of suspension of interest payments in the face of depleting foreign exchange reserves. Some observers also suspect that the completion of the financial packages for Argentina, Chile, and the Philippines--and the consolidation of the so-called menu approach--is not altogether unconnected to Brazil's suspension of interest payments. Of course, further development of the menu approach is effectively constrained by the well-known difficulties experienced by banks in agreeing among themselves on just about anything, except their collective desire to reduce exposure.

The banks' interest in participating more closely in program design, as noted in the capital markets paper, is chiefly motivated by the objective of reducing the absolute size of the financing gap as well as their own participation in the package. Despite the public embrace of the case-by-case approach, banks are often paralyzed by fears of setting a precedent, an obvious contradiction in terms. This affects especially the so-called nonsystemic countries such as Costa Rica in my own constituency. (Costa Rica signed a letter of intent with the IMF four months ago, but the financial package is not yet in place.) These countries face undue delays and all sorts of complications because banks are waiting to deal with larger clients first and do not wish to establish a precedent.

One of the most important developments on the debt front during the last few months has been the steep increase in the provision of loan-loss reserves by a major U.S. bank, a move which was quickly followed by other banks. It is mentioned in the capital markets paper that this move was motivated by competitive pressures (alluded to earlier) to improve their standing in debt and equity markets. Banks also acknowledge that market forces may compel them to increase their reserves in line with future exposures; admittedly, this will have a negative effect on new lending. Banks were also quick to point out that these provisions carried no implications of a willingness to forgive debt.

Apart from the contradictory stance implied by the refusal by the banks to grant debt relief while seeking to reduce exposure, the important issue is that it is increasingly evident that the wedge between the contractual and the market value of the debt is inhibiting resource flows to indebted countries. This point was brought to the attention of the Board during our discussion in March 1987 by the staff and some Directors, notably Mr. Massé. But the valuation of existing claims on indebted countries is also pointing to what seems to be one of the few viable solutions to the debt problem: that is, tailoring debt servicing to the market value of debt. In a way, the market is imposing its own solution on the debt problem, a solution which is paradoxically resisted by some of the most ardent advocates of market discipline.

There are several mechanisms by which debtor countries may benefit from the existing discounts. One of them is through debt/equity swaps, which usually result in a splitting of the discounts between the purchaser of debt in the secondary market and the debtor country. However, as pointed out in the papers, the scope for this type of operation is limited for well-known reasons. Other possibilities include different forms of debt buy-backs--Bolivian style--or the securitization of existing debt at market value. Within this type of mechanism, there are a range of possibilities which involve different degrees of generalization.

The G-24 report on the "Role of the Fund in Adjustment with Growth" calls for debt reconstruction schemes, which may be interpreted along the same lines as recent proposals to set up an international debt facility. This facility would buy debt at a discount and then write down its contractual value, passing on all (or a portion) of this benefit to the debtors. Such an initiative has indeed been incorporated in the U.S. Senate omnibus trade bill. While I realize that at the moment there does not seem to be enough support for the establishment of such a facility--and indeed the staff report comes out somewhat negatively on a "generalized" approach--I believe that this issue deserves careful attention and consideration. I will not pursue the point further at this time, but I expect that we will have the opportunity to deal fully with it in our next discussion on the debt situation.

To conclude, I would like to make a few comments on the staff's view on debt relief. First, regarding the issue of a generalized approach, the staff notes that the predominant view is that perhaps more diversification is needed, and that a more general approach may not offer the flexibility required to deal with different cases. I will only note that a strategy of international debt reconstruction may be perfectly compatible with a case-by-case approach, and debt relief may be granted on a conditional basis, thus weakening the arguments of those who claim that debt relief will impair or discourage adjustment efforts. Second, the staff mentions that "debt relief plans that force creditors to realize losses may be counterproductive in view of the flows of financing that may be needed in the future." To this I respond that, according to the market, the losses have already been incurred. Interestingly, a recent study done by Jeffrey Sachs of Harvard University shows that the implicit stock market valuation of developing country debt--reflected in the prices of the stock of banks with LDC credit exposure versus those without--coincides to a large degree with the secondary market valuation of existing debts. Thus, a buy-back scheme may conceivably improve rather than erode the financial position of banks.

To most observers, it is evident that the force of circumstances is already charting a course for the resolution of the debt problem. This course would adapt debt service payments to the capacity to pay--a necessary condition for recovering creditworthiness--and distribute with more evenhandedness the costs and benefits of adjustment. As mentioned in the staff papers "...a sustainable debt strategy will depend on maintaining a consensus on the sharing of this dividend in the future." The Fund, however, has the important role of ensuring that this be done in an orderly fashion, in a way that can minimize costs and consolidate the pace of structural reform that is an essential element of growth-oriented programs (the other half of the debt strategy). This matter will be the subject of another discussion.

Mr. Ismael made the following statement:

I generally agree with the staff's assessments contained in the various reports being discussed today. I note that satisfactory progress has been made in the past year in debt restructuring, with the Fund playing an increasingly important role. However, there is still a long way to go before major debtor countries can regain free access to the financial markets. In the meantime, the outlook for lending to smaller "nonsystemic" debtor countries has deteriorated, and new credit to the poorest debtors has all but dried up.

Good progress has also been made in strengthening the world financial system. With very little new money being extended, banks' credit exposure to countries in payments difficulties has been diluted. There has also been significant improvement in the capital ratio of the banks, as well as in their exposure to liquidity risk. The large provisions by U.S. money center banks have improved their standing in the debt and equity markets and will eventually allow them more flexibility in rearranging or disposing of their loan portfolios. Substantial initial progress has also been made in securing international agreement on supervising credit risk, while the system of monitoring worldwide credit flow has been extended and perfected. All these favorable developments have served to reduce the vulnerability of the world financial system. However, in the light of the mature stage of the present economic expansion in the industrial economies and the persistence of the imbalances in their trade and payments accounts, I tend to agree with the staff that considerable risk remains in the world financial system.

I can also agree that the success of the debt strategy depends fundamentally on the design of economic programs, with an adjustment path sufficiently steep to restore countries' creditworthiness over a reasonable time frame and a more equitable sharing of the dividend from the adjustment between the debtors and the creditors. In this respect, I note that banks have realized that it was in their interest to avoid a deterioration of debtor countries' payments status in order to safeguard the value of their assets. This is a healthy development for the success of the growth-oriented adjustment strategy. On the other hand, I must add that the debtor countries should exhibit a stronger political resolve to stand behind the programmed adjustments and to carry them through without delay. A fairer sharing of the fruit of adjustment with the creditors, together with a more equitable distribution of income at home, should serve to motivate the debtor countries to accept the adjustment program.

I believe that the Fund should continue to play an important role in the debt strategy. It should ensure that correct macroeconomic policies are pursued by industrial countries, particularly in this matured stage of economic expansion. In this respect, the reduction or the elimination of the imbalances in trade and payments accounts of some industrial countries will be a necessary precondition for a sustained and stable growth of the world economy. The Fund should also safeguard the free trade system from further erosion caused by the increased demands for protectionism so that the debtor countries will be able to seek improvement in their payments accounts.

I can understand the banks' reluctance to be the sole provider of new money to the debtor countries. In this regard, official assistance from the Fund and major creditor countries should be augmented. I agree with the view of the banks, as stated in the staff report, that for the poorest countries with very serious deterioration in their payments accounts, the situation might eventually have to be regularized by a negotiated reduction of claims. Creditor countries should, at these instances, be ready to offer financial assistance to enable such countries to stand on their feet again. Little attention has been given to the plight of those countries that are not the poorest but whose debts are not large enough to pose a threat to the financial system as a whole. These countries should receive the same attention and similar concessions given to the major as well as the poorest debtors.

Mr. Zeas made the following statement:

The informative and thorough staff papers help us focus on recent developments in capital markets and on the prospects for possible solutions to the foreign debt crisis. The papers face explicitly the question whether the debt strategy that the world has been following since 1982 requires major repairs rather than minor adjustments.

After carefully reading these documents, the members of this chair were left with the impression that there is not yet available a satisfactory lasting solution to the foreign debt crisis which is now facing several low- and medium-income countries, mostly from Latin America, although everybody will recognize that the debt strategy followed, at least at the beginning, staved off the possibility of a major international banking crisis.

The papers only study the financing aspects of the debt problem, although we all know that a lasting solution to the problem must involve financing accompanied by adjustment and an appropriate international economic environment.

At the outset, it is important to remind ourselves that the foreign debt problem carries the joint responsibility of lenders and debtors and therefore the solution will involve some sacrifice on both sides. Several medium-income countries have gone, for five years now, through adjustment and debt restructuring exercises, and they still face a medium-term outlook with substantial unfinanced gaps. Adjustments in imports, fiscal imbalances and interest rates, as well as frequent exchange rate depreciations attest to the adjustment efforts pursued by the debt-troubled countries. At present, however, we have eight Latin American countries unable to pay interest. The serious doubts about the current approach to the debt problem are vividly reflected in the increasing debt discounts in the secondary market, which have reached 45-55 percent and, in some cases, even 90 percent.

In the meantime, world economic outlook projections for 1987-88 indicate a possible per capita income growth of only 1.6 percent, compared with 3.1 percent in 1969-78, for countries with debt problems. Their terms of trade deteriorated by 18 percent during 1986; and, gross capital formation of the debt-ridden countries has increased, since the debt crisis began, at a rate equivalent to three fourths of that before the crisis; therefore, no substantial improvement in output growth can be expected.

Several "menu" innovations have recently been placed in the market, such as alternative participation instruments (or exit bonds); securitization for bank and nonbank creditors; interest capitalization; defeasance; short-term debt exclusions; higher fees for early fresh money providers; relending; and currency redenominations. Other innovations are being discussed. So far, the result has been a modest net repayment by the developing countries through international bank credit and bond markets during 1986.

To help explain the case of Latin America, I would like to quote part of a paragraph from the G-24 report, which says: "taking net transfer of resources as the difference between the net inflow of all capital and net payments of profits and interests, there was a net outward transfer of resources in the last five years totaling US$132 billion, an amount that is double the net inflows in the six-year period prior to 1982." Furthermore, I note that concerted lending to Latin America has exceeded voluntary lending since 1983 (SM/87/194, Table 13).

In addition, the majority of new financial instruments of the menu raise the costs of money as an effort is made to provide longer maturities for debtors. Consequently, there has also been a decline in the demand for credit by the LDCs because these countries have recently been more concerned with the high costs of their debt service. Thus, it seems there is an increasing reluctance on the part of certain LDCs to engage in further fresh borrowing (to repay interest), as these countries are more conscious now that real interest rates, including spreads, are still high; and, that until the recent deterioration of their terms of trade has been at least in part corrected, they will no longer be able to service their foreign debt, at face value, in the medium term without sacrificing significantly economic growth.

With respect to lending under the officially supported export credits, there has been a recent change in attitude on the part of the authorities who manage these facilities toward a willingness to lend to countries with a good track record of payments of short-term debt. However, during 1986, the exchange rate adjusted series indicate a moderate increase of exposure in developing countries of only $4 billion, equivalent to a 3 percent increase over the previous year.

Perhaps the only real breakthrough has taken place in the area of official development assistance, where some countries took the decision to convert old loans into grants. Also, in some cases, there has been a substantial reduction in interest rates and, at the same time, a lengthening of the maturities. Similarly, the debt buy-back devised for Bolivia appears encouraging, although there remain uncertainties about the amounts to be obtained from donor governments and about the price which the banks will be willing to accept for their debt assets.

The stock of debt owed by the heavily indebted countries reached nearly $400 billion at the end of 1986. Annual interest and spread payments due during 1987 and each year thereafter will surpass $29 billion. A 1 percentage point reduction in interest rates would reduce annual interest payments by $4 billion. At the same time, it is estimated that the same 1 percent reduction in interest rates would reduce pretax bank earnings by about 10 percent in 1987-89; this would not be a calamity by any means. This may indicate that there is indeed some room for a solution via further spread and interest rate reductions on the part of the banks.

In any event, it is our belief that for the present debt strategy to succeed, it will also be necessary to raise investment levels; to reverse the long-term secular decline of prices of primary commodities; to substantially reduce protectionism and subsidies to exports by major industrial countries; to achieve a permanent decline in real interest rates; and to further strengthen the international coordination of economic policy among industrial countries to promote faster growth.

In order to increase investment in the majority of the low-income countries, substantial amounts of loans, on concessional terms, are still needed for developing the basic physical infrastructure, such as drinking water systems, sanitation, sewerage, drainage, irrigation and flood controls, secondary roads, electricity plants, and so on. In order to achieve these goals in medium-income countries, the development banks must play an important role and, hence, we believe that substantial capital increases are urgently needed. The Fund should complement the short-term liquidity needs mainly through the stand-by and the compensatory financing facility, at least until the revamped structural adjustment facility enters into operation. The compensatory financing facility must be, as originally envisaged, a quick disbursing facility, free of conditionality.

Given the serious difficulties that will probably persist in the next two to three years and which create serious doubts that all the above-mentioned conditions will occur, we believe that it is time to begin to search for new solutions to the debt crisis.

The "menu" approach is the expression of a judgment that no generalized approach to finance in the narrow sense is likely to operate. A generalized new approach to financing, in the wider sense, which includes increasing a debtor's indebtedness as well as debt relief, may also be impracticable. Yet, one must recognize that, among the middle-income countries, the burden of existing debt for some is simply so large that it may not be possible for them to re-establish creditworthiness without some form of reduction of debts.

It seems to us that the Fund could play a major role in the development of such financing options. Even where the Fund is not itself engaged with its own resources, the Fund could play a very important role through its jurisdiction in the field of exchange restrictions, as well as in the examination of the financial implications of changes in financing, which may entail a variety of debt relief, interest rate reductions, and/or debt securitizations, which would transfer to the indebted countries the cost reductions that have already occurred on the discounted market value of the debt.

The Executive Directors agreed to continue their discussion at 3:00 p.m.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/87/129 (9/2/87) and EBM/87/130 (9/4/87).

3. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and Advisors to Executive Directors as set forth in EBAP/87/194 (9/2/87) is approved.

APPROVED: April 1, 1988

LEO VAN HOUTVEN
Secretary