MASTER FILES

ROOM C-130 04

NOT FOR PUBLIC USE

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/41

10:00 a.m., March 7, 1986

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	N. Toé, Temporary
	M. K. Bush
	G. Ercel, Temporary
	M. Arif, Temporary
	M. Sugita
	B. Goos
	Yang W., Temporary
	Jaafar A.
	J. R. N. Almeida, Temporary
T. P. Lankester	
H. Lundstrom	
M. Massé	L. Leonard
	P. E. Archibong, Temporary
	C. A. Salinas, Temporary
	J. E. Suraisry
	J. de la Herrân, Temporary
H. Ploix	
	J. de Beaufort Wijnholds
C. R. Rye	
	R. Msadek, Temporary
	A. Vasudevan, Temporary
S. Zecchini	N. Coumbis

L. Van Houtven, Secretary
B. J. Owen, Assistant

Also Present

European Department: B. Rose, Deputy Director; M. T. Hadjimichael, D. C. L. Nellor, G. S. Tavlas, H. Vittas. Exchange and Trade Relations Department: J. T. Boorman, M. R. Kelly. Legal Department: H. Elizalde. Research Department: L. Alexander. Personal Assistant to the Managing Director: R. M. G. Brown. Advisor to Executive Director: G. Nguyen. Assistants to Executive Directors: A. Bertuch-Samuels, B. Bogdanovic, F. Di Mauro, S. Geadah, G. D. Hodgson, Z. b. Ismail, S. King, M. Lundsager, K. Murakami, J. Reddy, J. E. Rodríguez, S. Simonsen, A. J. Tregilgas.

1. REPORT BY MANAGING DIRECTOR

The Managing Director noted that on March 4 he had paid a highly interesting visit to Canada, which had been admirably organized by the authorities. He had started the day with a one-hour conversation with the Minister of Finance, not only going over the Executive Board's discussion of the 1986 Article IV consultation with Canada but also having the opportunity, in addition, to comment on the budget presented by the Government to Parliament on February 26, which the Executive Board had not been able to examine. In his view, the budget was a major step toward fiscal stabilization, as it had included a sharp and decisive reduction in the budget deficit. He had also discussed with the Minister matters pertaining to the preparation of the meetings of the Interim and Development Committees and, more generally, the international monetary system. Subsequently, he had had a wide-ranging discussion with senior officials of the Ministry of Finance and other ministries and departments. He had then had the privilege of addressing the Senate on monetary affairs and the debt problem, followed by a lively exchange of views.

The Governor of the Bank of Canada had received him and had hosted an interesting luncheon, the Managing Director added. His conversation with the Prime Minister had also covered many issues, including the Canadian economic situation, the budget, and developments in the international monetary system. The Prime Minister had showed a keen interest in the major issues confronting the international community. The day had concluded with a dinner, offered by the Minister of Finance, and attended by a wide cross section of Ministers, officials, bankers, and businessmen, permitting a rare exchange of views on questions posed from many different angles. All in all, the occasion had been a manifestation of Canada's high regard for the Fund.

The Executive Directors took note of the Managing Director's report.

2. AUSTRALIA - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Australia (SM/86/26, 2/12/86; and Sup. 1, 3/5/86). They also had before them a report on recent economic developments in Australia (SM/86/30, 2/21/86).

Mr. Rye made the following statement:

> My Australian authorities regard the staff report as providing a very fair assessment of present conditions and policy issues. Developments have however moved quickly since the staff visit to Australia, and some--including an easing of monetary expansion, a fall in interest rates, and a slowing of domestic demand--carry implications for the staff's assessment.

Strong growth in activity and employment and falling real unit labor costs continued in 1985. Set against these achievements, however, was a further deterioration in the current account and a renewed acceleration in consumer prices. These adverse developments were not unexpected. Both were related to the sharp depreciation--20 percent on a trade-weighted basis--of the Australian dollar in the first half of 1985. Of the consumer price index increase over the year to the December quarter of 8.2 percent, close to 2 percentage points is estimated to be the direct exchange rate effect. Although the depreciation, together with a slowing in domestic demand, was seen as facilitating a reduction, after a time, in the current account deficit relative to GDP, a further increase in nominal terms was expected in 1985-86. In fact, the current account deficit in the first half of 1985/86 totaled $A 6.9 billion, compared with $A 5.7 billion a year earlier. In brief, as expected, the benefits of the depreciation are taking some time to come through and, in the meantime, economic policy must contend with the adverse short-term effects.

As the supplement to SM/86/26 notes, a further deterioration occurred late in 1985 in the outlook for the current account deficit for 1985/86--both in actual recent data and revisions to past data. For the most part, this has been attributable to higher than expected import volumes associated with a surge in domestic demand in mid-1985 and to further significant falls in world prices for many of Australia's rural and mineral exports.

The policy responses adopted by my authorities to cope with these challenges were generally in line with views expressed by Directors last year. Recent changes in the structure and operations of the Australian financial system have led to difficulties in judging the appropriateness of various settings of macroeconomic policy, but monetary policy was progressively tightened over the course of 1985 to moderate the unexpected quickening in domestic demand. A further tightening of fiscal policy was also implemented. As the staff has noted, the 1985/86 budget was the most disciplined for some time. The budget was designed to allow the private sector to expand and to take pressure off the economy as industry gears up to take advantage of the depreciation. The budget provided for a further substantial reduction in the deficit to 2.1 percent of GDP, a reduction of about half in two years.

Important tax reforms were agreed to in 1985. These are addressed primarily at the twin problems of a declining tax base and of high marginal rates of tax which have provided an incentive to avoid and evade tax and a disincentive to work and save. The main elements of the tax package include: taxing all major fringe benefits, with noncash benefits to be taxed in the hands of the employer; a system of full imputation credit for dividends received by resident shareholders; the taxation of real capital gains; a system for taxing the foreign-source income of Australian residents; and significant cuts in personal tax rates. Legislation is being introduced shortly to implement these measures.

The prices and incomes Accord between the Government and the trade unions was renegotiated during 1985, with the objective of offsetting the direct and indirect effects of depreciation on local inflation and thus on labor cost movements. My authorities expect the renegotiated Accord (Mark II) to ensure, in the forthcoming National Wage Case, that wages are discounted for the direct effects of depreciation on prices in calendar 1985; productivity gains of 3 percent to be taken in the form of enhanced superannuation benefits are spread over a two-year period; and earnings drift remains small.

As 1986 proceeds, my authorities expect some narrowing in the deficit on current account, both from the improvement in competitiveness and from a slowing in domestic demand. In their view, the uncertainty surrounding the projected improvement in the current account deficit relates more to its timing than its magnitude. The lags involved in the response of trade volumes to the changes in relative prices occasioned by a substantial currency depreciation are particularly uncertain. Also, the short-term consequences of an upward investment trend, which in the end will contribute heavily to import substitution and export generation, are adverse to the balance of payments because of the import-intensity of investment. However, past experience suggests that the turnaround in the external accounts, when it comes, will be quite sharp.

Recent statistical evidence suggests that a substantial response to improved competitiveness may already be emerging. Despite the strong growth in retail sales, imports of consumer goods showed no increase in value during the last six months of 1985. It would seem that improved competitiveness is already helping to switch the sources of supply from imports to Australian producers.

One question to be addressed is whether domestic demand is excessive, having regard to the balance of payments and to domestic costs. On that matter, evidence of a slowdown is accumulating. Housing is the clearest example, where building and finance approvals fell sharply in the December quarter. Retail sales increased at a slower rate in the December quarter than earlier in 1985. Two recent business surveys by Australian banks also point to a slowdown in 1986.

Indeed, one fear may be that prolonged high interest rates could deter the investment necessary to take advantage of the potential benefits of improved competitiveness. While recent exceptionally high interest rates, well into double figures in real terms, are no doubt a deterrent in some cases--clearly so to the more credit-sensitive areas of the economy--overall investment expectations appear to be holding up.

However, the consequences of the further monetary tightening in November have only just begun to show up in the measured indicators, and credit and monetary aggregates are likely to slow further in the months ahead. The staff says, on page 19, that it "would still argue against any significant relaxation of monetary policy," and, on page 20, that "an approach that errs somewhat on the side of caution would seem to be in order." My authorities broadly agree with these statements. But they note that demand for credit has slackened and that the monetary aggregates, difficult as they are to interpret, have slowed sharply in recent months. Against increasing signs that tight financial conditions are beginning to affect real activity, the Government has recently allowed the interest rates under its control to follow cautiously the downward trend in market rates. This is regarded not as a weakening of the stance of monetary policy but as an appropriate response to the easing in the demand for credit and in domestic spending.

In a longer-run sense, further fiscal restraint would reduce the need to rely heavily, perhaps too heavily, on monetary policy. In this regard, the Government remains committed to continuing restraint in its budget policy. It is important to recognize here the contribution of the trilogy, as outlined on page 9 of the staff paper. These unprecedented commitments entail the imposition of comprehensive fiscal discipline for the remainder of the Government's term and are of central importance to economic strategy. Meanwhile, the Government's tax reform proposals are to be funded without additions to the deficit. Over the months ahead the Government will be considering how best to bring together these various fiscal strands. Further decisions to restrain the growth in public sector outlays and borrowings will be necessary. I agree with the staff that this must include the state and local government sector, which now has larger spending and borrowing programs than the commonwealth sector.

The Accord with the trade union movement continues to be a cornerstone of the Government's economic policy approach. It is clear that to sustain the improvement in Australia's competitiveness will require continued restraint in labor costs. In this regard, my authorities believe that the Accord Mark II will ensure that real unit labor costs increase only marginally in 1986-87, following large reductions in each of the three preceding years.

Should inflationary pressures worsen unexpectedly, the Accord provides scope for the Government to reopen wages policy with the trade unions.

Although increases in prices in Australia are likely to be rather faster than in most of its competitors over the next two years, the differential should be narrowing. The expectation now is of a rate of inflation by mid-1986 not much exceeding 7 percent and continuing down thereafter. On this basis Australia should surrender only a modest portion of last year's improvement in competitiveness. That would be a good outcome by past Australian standards. To achieve it, however, will require that the Government's economic strategy is not shifted off course by pressures which are likely to remain intense in the period ahead.

Mr. Wijnholds considered that Australia's performance in recent years in respect of growth and employment was commendable. A relatively high growth rate and the capacity to absorb a relatively large increase in the work force was of course to be expected of a country still in the process of developing its considerable natural resources. However, as the staff had made clear, the Australian labor market posed particular problems, with strong union activity and wage indexation complicating the task of attaining high growth with low inflation. Another complicating factor was Australia's dependence on foreign capital, making it impossible to ignore external adjustment for long. Indeed, in the previous year, economic agents had judged Australia's external position unfavorably, and the exchange rate had taken two heavy falls, thereby aggravating inflationary pressures. In the meantime, the authorities had tightened demand policies and reached a new agreement with the trade unions on wages.

While he accepted that incomes policy could not be dismissed in Australia under present circumstances, he agreed with the staff that the new prices and incomes Accord, which played such a central role in the Australian context, would be a formidable challenge, Mr. Wijnholds continued. In particular, the reduction in the wage increase by 2 percentage points below the increase in the consumer price index in order to take account of the exchange rate depreciation was well below the estimated effect on prices of the first part of the depreciation, of 5 percent. If price pressures did not abate soon, a renegotiation of the Accord might prove necessary. The apparent absence of employers in the consultative process was also a fundamental weakness in the Accord. He wondered whether ways could not be found to include all the social partners in reaching a consensus on incomes.

A positive development of fiscal policy was the considerably lower budget deficit foreseen for 1985/86 as a percentage of GDP, Mr. Wijnholds noted. However, there appeared to be some softness in that improvement, as the high increase in revenue projected was partly due to the large increase in profits remitted by the Reserve Bank. It was always gratifying if central banks could contribute to government revenue, but at the same time such remittances were known to fluctuate strongly. He agreed with the staff that a further reduction of the total public sector borrowing requirement (PSBR) was desirable in order to increase the availability of savings to finance investment and to promote external adjustment. The tax reform package of September 1985 had been useful but unfortunately it was not revenue neutral. The additional expenditure restraint required to neutralize the loss in revenue might prove difficult to obtain. The so-called trilogy of fiscal commitments was based on solid principles, but effective action would be needed to ensure that it was made effective.

The authorities' decision to rely on a wide range of indicators in assessing monetary developments was understandable in view of the recent deregulation of the financial system, Mr. Wijnholds remarked. Nevertheless, care should be taken not to take advantage of uncertainty concerning the interpretation of monetary aggregates to follow a too accommodative monetary policy. Fortunately, monetary policy in Australia had become firmer over the course of the past year. The high rates of interest that had come to prevail might be indicative of tight monetary conditions but not necessarily so; they could also--and even primarily--reflect loss of confidence in the Australian dollar, requiring the payment of higher interest rates to attract capital. Even though the monetary aggregates were distorted by deregulation, which had led to reintermediation, their rate of expansion should not be overlooked. The recent slowing down in the expansion of monetary aggregates was welcome, but the staff view that any relaxation of monetary policy under present circumstances would be unwise remained fully valid. He would even go so far as to say that in view of the rather unsatisfactory rate of price increase and the low level of the exchange rate, which should not be allowed to fall farther, an easing of monetary policy at the present time would be dangerous.

On a more general point, Mr. Wijnholds considered that Australia's combined nonadherence to any form of monetary or exchange rate targeting posed a rather fundamental problem. A floating exchange rate regime was probably the best one for Australia, although, clearly, the authorities could not allow the rate to fall below a certain level, making some degree of management inevitable. But even with a mild form of managed floating, the absence of any kind of monetary target or norm left the country without an instrument for imparting discipline. Therefore, it seemed desirable for Australia to return to some form of monetary targeting when the distortionary effects of deregulation had worn off.

He had been pleased to note that the staff report dealt extensively with matters such as the exchange rate and Australia's external indebtedness, Mr. Wijnholds observed. While the ratio of external debt to GDP had risen sharply in recent years--half of the increase being due to the depreciation of the Australian dollar--it was not, at 33 percent, a cause for immediate alarm. Nevertheless, a continuation of the trend could cause problems. A reduction of the current account deficit, for which the conditions seemed to have been met, as well as a reversal of the increased reliance on borrowing rather than on nondebt-creating flows, was therefore desirable. The staff's medium-term scenario was instructive in showing how higher direct investment from abroad would bring down the ratio of external debt to GDP, as well as contain the increase in the gross debt service ratio, which would otherwise reach the quite high figure of 42 percent in 1990/91.

To conclude, Mr. Wijnholds commented that recent policy actions had clearly been in the right direction but care should be taken to sustain the adjustment effort so as to avoid endangering the impressive gains in income and employment.

Mr. Sugita noted that the strong recovery since mid-1983 of the Australian economy had continued in 1985. With the continued strength of private consumption and the modest recovery of business investment, economic growth had become more broadly based. Real unit labor costs had fallen, and there had been a recovery in business profitability. The unemployment rate had also declined. The overall strategy of economic management pursued by the authorities in recent years seemed to have contributed to those good results.

At the same time, however, the economy had given rise to certain risks and concerns, Mr. Sugita observed. First, the growing current account deficit appeared to be unsustainable in light of Australia's already large external indebtedness; second, labor costs threatened to increase in the context of the strong economic upturn; and third, the significant decline in the exchange rate might pose an inflationary threat. The prices and incomes Accord had worked well so far, perhaps even better than originally expected, as evidenced by the continued decline in real unit labor costs. Given the unique and difficult problems in Australia's labor market, the social contract would continue to play an important role in overall economic management. While the Accord contained a certain degree of flexibility, the increased pressure on labor costs that was expected to arise from higher economic activity and the currency depreciation seemed to indicate the necessity of firm financial policies, possibly even firmer than previously.

The 1985/86 budget represented an important step in that direction, Mr. Sugita continued. Reflecting the expenditure rationalization measures announced in May 1985, the rate of growth of expenditures in real terms was just over 1 percent, mostly on account of an increase in interest payments for government debt, in contrast with a rate of 6 percent in the previous budget. In fact, interest payments accounted for 9.7 percent of total outlays in the 1985/86 budget, an increase over the previous year of 11.1 percent in real terms. Thus, there was no doubt that the interest cost of past deficits had become a significant burden on the budget.

Looking ahead, a cut in the personal income tax was to be implemented in 1986/87, in line with the authorities' commitments under the Accord, Mr. Sugita mentioned. Although the tax cut had been incorporated in the comprehensive tax reform measures announced in September 1985, the growth of expenditures would have to be further contained in order to achieve a continued reduction in the budget deficit for the next fiscal year. Incidentally, he wondered what had prevented the inclusion of a broadly based consumption tax among those measures.

The rate of growth of monetary aggregates had accelerated throughout most of 1985, Mr. Sugita observed. While the recent changes in the financial system made interpretation of the movements of monetary aggregates difficult, the growth of money and credit still seemed to be on the high side. During the course of 1985, monetary policy had been tightened twice, in February and in November, when the Australian dollar had come under strong pressure. As a result, interest rates had risen to a very high level. However, in spite of the concerns about the possibly unfavorable effects of those rates on economic activity, a significant relaxation of monetary policy under present circumstances would be unwarranted, and it was encouraging to note that the growth of monetary aggregates had finally started abating in late 1985.

He noted with some concern that the level of business investment had not responded very vigorously to the expansion of economic activity in 1985, although it had risen modestly from a low level, Mr. Sugita went on. That trend was intriguing, particularly in view of the considerable improvement in business profitability in 1984 and 1985. Mr. Rye had cited high interest rates as an important factor underlying the sluggishness of business investment, and he would welcome additional comment from the staff. To the extent that the slow recovery in private capital spending was related to inadequate business confidence in the management of macroeconomic policy, sound financial policies formulated in a medium-term framework--perhaps beyond the period envisaged by the trilogy--might contribute to enhancing growth potential in the longer perspective.

During the past year, Australia's international competitiveness had improved, largely as a result of the fall in the nominal effective exchange rate, Mr. Sugita remarked. Any further depreciation might be counterproductive as the resulting inflationary pressure would endanger the maintenance of the Accord, the framework on which economic policy was built at present. The authorities' task at the present juncture was to transform those gains in competitiveness into an improvement in the external position by means of appropriate financial policies.

Inward equity investment could play a more important role in medium-term debt management, Mr. Sugita considered. In that respect, while he welcomed the recent modifications to the regulations on foreign investment, which had been announced in October 1985, further efforts in that direction were necessary from a medium-term point of view.

Finally, the level of protection in the industrial sector in Australia had traditionally been high, Mr. Sugita observed. Although he welcomed the Government's draft plan for gradually phasing out existing tariff quotas over the medium term, he joined the staff in wondering whether the speed of trade liberalization could be accelerated.

Mr. Jaafar noted that the Australian economy had performed well in the past financial year, and a similar performance was fortunately expected for 1985/86. Real GDP growth was expected to be 4 1/2 percent, following closely the strong 5 percent annual rise over the preceding two fiscal years. Business fixed investment had shown a healthy recovery, and the rate of unemployment had been reduced to one of the lowest levels in recent years. Inflation also seemed to be under control, although it was still less than satisfactory, at about 6 percent in 1984/85, having fallen from the high of 11 1/2 percent in 1982/83. However, the external current account had not shown any improvement, the deficit having deteriorated to 5 percent of GDP in 1984/85 compared with about 4 percent in the preceding two years.

The evolution of Australia's economic policies had been broadly in line with the views expressed by the Executive Board during its consideration of the 1984 Article IV consultation (EBM/85/25, 2/20/85), Mr. Jaafar noted. He was confident that those policies, firmly pursued, could result in further improvements in economic performance in 1985/86.

Referring to the main policy areas, Mr. Jaafar noted that there was no doubt that incomes policy was constrained by a highly unionized work force and a strong tradition of wage indexation. Within those constraints, the Accord between the Government and the Australian Council of Trade Unions (ACTU) had been successful in moderating wage increases, and indeed in reducing real unit labor costs in each of the past three financial years. It had also resulted in a significant increase in the share of profits in gross national product and had thereby provided the incentive for new investments and for job creation. Three recent developments suggested that the Accord would play an even greater role in stabilizing the economy in future. First, the successful completion of the negotiations between the ACTU and the Government on extending the life of the Accord would ensure industrial and price stability for another two years. Second, the parties had recognized that price increases emanating from the depreciation of the Australian dollar should not be fully indexed. And third, the trend toward partial compensation for changes in prices, as well as for changes in productivity, was essential if the exchange rate depreciation was to have a positive impact on the balance of payments.

While he agreed with the authorities that the risk of a buildup of wage pressures became greater the longer the Accord remained in place, he did not believe that viable alternatives existed at the present time, Mr. Jaafar went on. A return to the system of free collective bargaining would be premature and could prove damaging. What was needed was a combination of tight monetary and fiscal policies, together with a flexible system for determining wage increases under the Accord. In that way, wage and price stability would be maintained. One novel--and, perhaps, positive feature in the Accord, although Mr. Wijnholds had commented on it adversely--was the noninvolvement of the employers in the consultation process. It seemed to him that the interests of the employers were taken care of adequately even without their participation in the Accord. The gross operating surplus of the company sector had risen by 70 percent since 1982, and real unit labor costs had fallen by 7 percent during the same period.

He supported the three main objectives of fiscal policy--namely, to reduce the deficit as a proportion of GDP, to reduce government expenditure as a proportion of GDP, and to avoid any increase in tax revenue as a proportion of GDP, Mr. Jaafar stated. The trend in public finances suggested that those objectives could be met in the year ahead. In particular, he welcomed the reduction in the fiscal deficit to 3.3 percent of GDP in 1983/84 and the projected further reduction to 2.1 percent of GDP in 1985/86. Revenues had proved to be quite buoyant, and in the current financial year the authorities had made a commendable effort at keeping the rate of real expenditure growth at 1 percent. Those positive developments would no doubt improve resource availability and the growth potential of the private sector, particularly in export industries. In present circumstances, the emphasis on expenditure restraint remained appropriate.

On monetary policy, Mr. Jaafar said that he agreed with the staff that monetary targeting was no longer viable in Australia. The deregulation of the financial system had been a mixed blessing: it had brought efficiency to the system but at the same time it had made the conduct of monetary policy more difficult. In those circumstances, he supported the use of a wide range of indicators to reach a judgment on the direction of monetary policy. The tight monetary policy stance should be continued; despite high interest rates, the environment did not appear to allow for any relaxation.

As for exchange rate policy, he endorsed the absence of a particular exchange rate target, Mr. Jaafar continued. The depreciation of the Australian dollar in 1985 had been a welcome development, since without it, the current account position would have been much worse. He was not sure that he fully understood the respective positions of the staff and the authorities on the exchange rate. The staff had suggested on page 13 of SM/86/26 that the exchange rate appreciation might have overshot in the short run; at the same time, it was stated that central bank intervention had increased from $A0.7 billion in 1984 to $A1.7 billion during the first 11 months of 1985. That seemed to suggest that the overshooting had been offset. At the same time, he did not fully understand the position of the authorities, who stated on the one hand that they had no particular exchange rate target in mind, whereas their intervention activities tended to suggest that they did. He would appreciate an explanation of that apparent contradiction.

Australia was perhaps one of the best examples of a country that was suffering from protectionist policies practiced by other countries as well as by itself, Mr. Jaafar concluded. The high level of protection granted to the industrial sector had resulted in distortions in resource allocation and in major inefficiencies. At the same time, Australian agricultural exports were facing barriers elsewhere. A more open trading system in Australia and other industrial countries would contribute to a better allocation of resources on a global scale and would make external adjustment much easier. He therefore joined the staff in asking the authorities to make speedy progress in reducing Australia's protectionist barriers.

Mr. Goos commented that, notwithstanding an ongoing good performance in terms of overall economic growth and employment, the Australian authorities had recently been, and obviously had continued to be, confronted with difficult policy choices. The task of defining and implementing the appropriate policy course was certainly not facilitated by their ambitious aim of redressing domestic and external imbalances while at the same time maintaining growth of output and employment at high levels. Indeed, given the risks and uncertainties surrounding the present situation, he could not but agree with the staff's diplomatically phrased assessement that "it would be a major achievement if this challenge could be met." Against that background, it was gratifying to note that the authorities had adopted policy corrections that were broadly in line with the earlier recommendations of the Board. He commended them in particular for their flexible response to developments in the exchange market. Nevertheless, the question remained whether those corrections had been sufficient and to what extent restrictive financial policies would have to be maintained in the foreseeable future.

While the recent relative stability in the exchange rate of the Australian dollar suggested that overall economic policies had been brought onto a more appropriate course, Mr. Goos continued, several worrying features gave rise to questions. First and foremost, there was the strong and--as he gathered from the supplementary paper--unabated increase in the current account deficit combined with an unsustainable buildup of external debt. Second, interest rates were very high, and according to recent figures, the rate of monetary growth seemed to remain also on the high side--notwithstanding the recent quite pronounced deceleration and the difficulties in assessing the appropriateness of those figures. Third, there were doubts about the appropriateness of the prices and incomes Accord with respect to the need to insulate wages against the immediate effects of the recent devaluations on the domestic price level, and the Accord's ability to prevent a breakout of cost and price pressures. Fourth, slippages were anticipated in the budgetary targets for 1985/86.

Those features seemed, at least to some extent, to be interrelated, Mr. Goos continued, and they probably lay at the heart of the previous year's difficulties in the exchange market. The implication seemed to be that the authorities had gone too far in stimulating the economy and that their intention to withdraw the stimulus had been considered as too hesitant by the markets. While the accuracy of that assumption might be difficult to prove, the authorities would be well advised to follow the staff's recommendation to err on the side of caution in striking a proper balance between growth and adjustment.

In any event, there was no scope at present for relaxing monetary policy, Mr. Goos considered. He had great sympathy for the authorities in their concern about the potential repercussions of the high interest rates on real economic activity. That concern led him to wonder whether monetary policy should not place greater emphasis on more direct global control of the growth of credit and the main monetary aggregates instead of relying predominantly on influencing the cost of funds in the money markets. In the absence of sufficient restraint in the underlying supply of liquidity, any attempt to curtail domestic credit demand by raising the cost of funds was bound to produce very high interest rates in the specific circumstances prevailing in the Australian economy. Those circumstances were characterized by the deregulation of the financial system and the introduction of financial innovations; the weakening in price performance and the concomitant revival of inflationary expectations; and, as far as the experience of 1985 was concerned, the strong depreciations, which had probably been preceded by equally strong expectations of depreciation. In the latter respect, he would not be surprised if further analysis showed that part of the accelerating demand for domestic credit had found its way into exchange rate speculation against the Australian dollar. It was obvious that astronomically high short-term interest rates would have been required to discourage such speculation if the actual depreciations were taken as a proxy for the magnitude of the preceding expectations.

To conclude on that point, Mr. Goos suggested that more emphasis should be placed on monitoring and controlling monetary aggregates in order to ensure an appropriate degree of restraint. He was of course aware of the problems involved in establishing a meaningful relationship between such aggregates and developments in the real economy. Nevertheless, as the Executive Board had recommended on the occasion of the 1984 Article IV consultation with Australia, the authorities should make every effort to reinstate some form of monetary targeting in order to strengthen the credibility of monetary policy, a point that had also been made by Mr. Wijnholds. In that context, it was conspicuous that the first attack on the Australian dollar during February 1985 had occurred only a few weeks after the decision to discontinue monetary targeting.

Referring to fiscal policy, Mr. Goos observed that the necessary correction of the external current account deficit as well as emerging cost and price pressures pointed clearly to the need for continued fiscal restraint and a further reduction in the fiscal deficit. That task would appear to become even more difficult in the 1986/87 budget than in the budget for 1985/86, given the additional burden resulting from the tax reform package, the cut in income taxes, and the recent decline in oil prices. Quite disturbing additional features in that respect were the rapidly increasing share of debt service payments in total public expenditures and the fact that a significant part of the deficit reduction budgeted for 1985/86 reflected cyclical and temporary factors, like the profits remitted by the central bank.

In view of those difficulties and developments, it was reassuring that the authorities had recently announced their intention to effect additional drastic cuts in government expenditures, Mr. Goos commented. Expenditure would probably have to bear the brunt of the necessary deficit reduction, given the already high tax burden. In any event, failure to reduce the fiscal deficit further would pose a clear threat to external and domestic stability and would risk undermining the prices and incomes Accord. By comparison, a further deficit reduction would entail little risk of choking off the recovery, in light of the apparent strength of private domestic demand, and it should also help to bring down interest rates.

Notwithstanding the important and successful contribution of the Accord to the authorities' strategy, Mr. Goos reiterated his view that incomes policy, if any, should be relied upon only as a short-term device. While it might not be suitable to abandon that instrument in present conditions, the authorities should prepare the ground for phasing it out in the not too distant future. Of course, that would require the pursuit of even firmer financial policies in preparation of such a move in order to avoid what the staff had called in another context the "re-entry problems" associated with the return to free wage bargaining. For the time being, however, the staff was certainly right to recommend an amendment to the current Accord to the effect that the additional price increases resulting from the recent depreciations would not be allowed to affect wage adjustments.

In conclusion, Mr. Goos said that he wished to commend the Australian authorities for their management of their economy--which was successful overall but not without problems--including their concern with structural reform, notably in the area of financial deregulation, taxation, and, most recently, foreign investment. More decisive progress would have been desirable, however, with respect to the continued high protection of Australia's industrial sector. The recent pronounced devaluation should provide an excellent opportunity to accelerate the process of liberalization, which in turn would make an important, if not crucial, contribution to the effectiveness of that devaluation by improving competitiveness and supporting the necessary adjustment in the external accounts. He expressed his general support of the staff appraisal.

Mr. Toê remarked that it appeared from the staff report and Mr. Rye's statement that Australia's economic performance in 1985 had been mixed. On the one hand, the recovery had continued at a strong pace, the rate of unemployment had declined, and unit labor costs had continued to fall. Furthermore, the Commonwealth budget deficit had been reduced, although at a slower pace than would have been desirable in order to permit the PSBR to be reduced markedly, thereby freeing resources for the private sector. On the other hand, the current account deficit had widened further and the external sector, particularly the Australian dollar, had come under increasing pressure. In addition, as Mr. Rye had reported, there had been a renewed acceleration in consumer prices.

In the real sector, where output had increased by almost 5 percent in 1984/85, it was refreshing to note that the private sector had contributed to some extent to economic growth, whereas in previous years, the revival of economic activity had stemmed primarily from the expansionary fiscal policy stance of the Government, Mr. Toé continued. Indeed, the data in Table 1 of SM/86/26 indicated that the declining trend in private gross fixed investment had come to an end in 1984/85, when it had grown by almost 7 percent. The latest information provided by the staff on domestic economic developments was all the more encouraging as it confirmed the strengthening of the favorable trends observed so far in the various domestic sectors of the economy. It was also encouraging to note that the economic strategy adopted by the Government when it took office was working rather well. The economic expansion recorded over the past three years had led to the creation of employment opportunities; as a result, the unemployment rate had fallen to less than 8 percent of the labor force at the end of 1985.

While commendable developments had taken place in the labor market, Mr. Toé continued, a word of caution seemed necessary because the lack of flexibility in determining wages, owing largely to the system of semiannual indexation, appeared to pose a potential threat to future employment opportunities. In that respect, the Government's efforts to introduce some moderation in the wage award was welcome, the more so that future wage increases would be lower than the rate of inflation and labor productivity. However, he wished to stress the inherent risk associated with the Accord in the sense that it was likely to break down if a labor shortage emerged in key sectors. In that connection, the staff had mentioned a risk of substantial wage drift as a result of competition among employers for categories of labor that were in short supply and although it had stated that ways had been found to avert such a risk so far. Early and serious attention should be paid to that problem since the risk of spillover effects in other sectors could not be avoided indefinitely.

The fiscal outturn had improved less rapidly than expected, Mr. Toé observed, with the commonwealth budget deficit having been reduced by 1 percentage point to slightly above 3 percent of GDP in 1984/85. However, the improvement had stemmed largely from buoyant growth in government revenue rather than from discretionary action by the authorities to raise revenue or rein in expenditures. The continued expansion of government expenditure was therefore a major source of concern since it could place a great deal of pressure on prices, including interest rates, thereby wiping out much of the progress achieved so far. In that context, it was reassuring to know that the Australian authorities were well aware of the need to maintain fiscal discipline over the medium term and that they had accordingly adopted a set of fiscal commitments that would remain in force until December 1987. Translating those commitments into concrete action, the 1985/86 budget addressed the fundamental problem of the rapid increase in government expenditure, by contemplating a substantial slowdown in its rate of growth to 1 percent in real terms, down from the high level of over 6 percent recorded annually since 1982/83. He hoped that the fiscal restraint could be sustained because the fiscal reform under way might reduce revenue and, consequently, widen the deficit.

In the monetary sector, the deregulation of the financial system with a view to increasing its efficiency was a welcome development, Mr. Toé considered. But the rapid expansion in the liquidity of the economy that had followed was somewhat disturbing. Inflationary expectations could be rekindled, thereby weakening the effects of government efforts to stimulate private investment. However, he had been encouraged by Mr. Rye's observation that the growth in monetary aggregates had slowed down in recent months. Nevertheless, a cautious monetary policy would have to be maintained.

As for the external sector, the deterioration of the current account reflected not only expansionary demand management policies but the lack of competitiveness of the industrial sector due to excessive protectionist measures, Mr. Toé concluded. It was therefore gratifying to note the authorities' resolve to restructure the manufacturing sector and reduce trade barriers. His chair shared the concern of the Australian authorities over the recent trend toward bilateral agreements, which had serious implications for smaller economies. Finally, he welcomed the introduction of a uniform system of tariff preference for all imports from developing countries in an effort to open the Australian market to their products.

Mr. Zecchini said that the overall performance of the Australian economy in 1985 could be considered positive, if judged in terms of the expansion of GDP and the reduction in unemployment. Output had continued to grow at a remarkable rate compared with growth in the industrialized countries. That had made it possible to achieve a crucial objective, a sufficient expansion of employment to reduce the unemployment rate. Very few industrial countries could claim the same measure of success in that respect. However, economic trends in 1985 had also shown the first signs of some creeping tensions on two fronts: measures of inflation--in terms of both the nonfarm product deflator and consumer price index--were on the rise; and the deficit in the current account had continued to increase as a ratio to GDP. But those tensions were undoubtedly neither large enough nor so deeply rooted as to suggest that the Australian economic strategy was bound to fail.

Since 1983, the Australian authorities had pursued an economic strategy based mainly on three instruments: incomes, fiscal, and monetary policy, Mr. Zecchini continued. While incomes policy had been assigned the task of checking inflationary pressures, fiscal policy had borne the brunt of giving the initial impulse to economic recovery, leaving a supporting role for monetary policy. That strategy could be labeled as a Keynesian experiment that stood in complete contrast with the so-called British experiment. The latter relied mainly on monetary and fiscal stringency to induce discipline on the wage and inflation fronts, and consequently to leave more room for the expansion of the real side in the price/quantity mix of nominal GDP growth.

The Australian experiment had produced impressive results until the first months of 1985, Mr. Zecchini noted. It had been possible for real GDP to grow rapidly, together with employment and productivity; unit labor costs and inflation had declined; and external competitiveness had been preserved, owing also to the flexible management of the exchange rate. However, the experiment had reached a turning point in 1985 in terms of what the most appropriate policy mix should be in the second stage. In brief, how could Australia consolidate the positive results already achieved and at the same time reabsorb the external imbalance while preserving strong economic growth and monetary stability? That was also the basic issue that the authorities would have to face in the current year. Dealing with it would require the use of the same three economic levers as in the past three years, with the same relative intensity but with a different orientation. Incomes policy should be aimed at mitigating wage pressure on costs and maintaining a parallelism between differences in earnings and relative productivity in the various sectors. Fiscal policy should be oriented toward containing domestic absorption, while monetary and exchange rate policies should take responsibility for creating monetary conditions that were not only compatible with price stability but also conducive to the expansion of fixed investment and to the diversification of the export structure.

Taking up incomes policy first, Mr. Zecchini remarked that the Accord had apparently not ensured full indexation of wages to inflation. The coverage had been less than 100 percent if the rates of award were compared with changes in consumer prices or consumption deflators. In spite of a certain incidence of wage increases above the award, the same conclusion held true for real average earnings on a national accounts basis which had remained stable in 1984/85, after declining in 1983/84. Together with sharp productivity increases, the outcome had been a reduction of the wage share in nonfarm output, as illustrated in Chart 3 of SM/86/26. In the face of less than full protection against inflation, it was crucial in the wage negotiations for 1986 and 1987 that the inverse relationship between real wage increases and rises in the level of employment be fully understood by all social partners. Specifically, any attempt to offset the limited erosion of real wages in the past should be perceived as triggering an appropriate financial policy response that, while aiming at preserving monetary stability, would negatively affect the level of economic activity and employment.

At the same time, consideration should be given to the impact of the periodicity of the indexation mechanism, Mr. Zecchini observed. As Chart 2 in the staff report clearly showed, the time lag involved in the operation of that mechanism had led to an overshooting of real labor earnings in periods of rapidly declining inflation rates. His chair had raised that point during the discussion of the 1984 Article IV consultation with Australia. The remedy was not to be found in adjusting the indexation lag. In fact, a reduction of the lag would enhance the propagation of inflationary shocks over time while a lengthening of the lag could accentuate the overshooting effect. A more viable approach would consist of limiting the consequent real wage increase to the size of possible productivity gains.

It was important for the Fund to explore further the contribution of incomes policy in the attainment of macroeconomic objectives in the Australian case, Mr. Zecchini considered, because useful lessons could be drawn from it for the design of adjustment programs in general. For instance, it might be advisable to test the hypothesis that incomes policy tended to be rejected by the unions whenever an accommodative monetary stance was perceived as a viable alternative for reducing the costs of prolonged compliance with incomes agreements.

Referring to fiscal policy, Mr. Zecchini noted that the recovery of economic activity in fixed investment constituted a strong argument in favor of withdrawing the fiscal impulse. That had been recognized by the authorities in shaping up the 1985/86 budget, which aimed at reducing the total PSBR to 4.6 percent of GDP. However, the causes of some slippages that had occurred in previous years had not yet been overcome. For instance, the contribution of states and local authorities to the reduction of the PSBR was still inadequate. Moreover, the accumulation of large financial reserves by those authorities might point to some lack of effectiveness in the control of the budgeting process of state and local institutions. The system of voluntary global limits on borrowing did not seem capable of remedying that problem. A more effective approach was represented by the so-called trilogy of fiscal commitments. The initial progress made in that direction under the 1985/86 budget needed to be followed by more substantial measures, especially in limiting expenditure at both the central and regional levels. If institutional constraints prevented the enforcement of such limits, other rules--such as binding limits on the PSBR--should be considered.

As to monetary policy, its initial role of supporting the Government's growth strategy should give way to a more cautious policy stance that assigned a higher priority to restraining inflation and to restoring a sustainable balance of payments position, Mr. Zecchini commented. But the means by which that strategy had been implemented recently was debatable. The rise in short-term interest rates, specifically on 90-day bank bills, was roughly in step with a steep rise in monetary aggregates as measured by M3. That trend was clearly in contrast with the previously established inverse relationship between interest rate changes and monetary expansion. He understood that the reintermediation of the banking system had played a role in breaking the past correlation between the two variables. However, he had had difficulty finding in the staff reports a reasonable explanation of the causes of that reintermediation and an assessment of the contribution of excess credit demand in fostering interest rate rises, keener competition between bank and nonbank institutions, and consequently the reintermediation itself. Moreover, if it was accepted that the explanatory value of the behavior of monetary aggregates was impaired by structural changes in past functional relationships, how should the appropriateness of the degree of monetary stringency be gauged?

Some clarification of those points was called for, Mr. Zecchini remarked. For instance, in the first two months of 1986, monetary expansion had dwindled, and nominal interest rates had also declined. Did that positive correlation indicate both a newly acquired understanding of a crucial relationship between monetary aggregates and interest rates, and a consequent adjustment of the degree of monetary stringency? That recent monetary development might have increased market uncertainty about the adequacy of the present policy stance, thereby inducing a further weakening of the effective exchange rate of the Australian dollar in the first two months of 1986. Similar uncertainties, coupled with expectations of accelerating inflation, might also have contributed to the sharp depreciation of the Australian dollar in 1985 in spite of the rapid increase in the positive differential with respect to interest rates abroad.

In contrast, exchange rate policy appeared to be an area where the authorities should strive for greater stability in the current year, Mr. Zecchini considered. Any further depreciation could actually add to inflationary pressure and, consequently, either endanger the maintenance of the incomes policy or increase the cost for public finances, delaying the reabsorption of the fiscal deficit. In that respect, it should be recalled that the Government had had to agree on a reduction of personal income taxes to compensate for the discount on the national wage increase that had been necessary to sterilize the direct effects of the 1985 depreciation. At the same time, it would not seem advisable to allow an appreciation of the real exchange rate because of the negative impact on exports, other than exports of rural and mineral products, which needed to be promoted if Australia's export capacity was to be sheltered from the declining trends of world commodity prices.

Mr. Leonard considered that the staff had drawn carefully balanced conclusions that were most apt to the issues facing Australian policymakers. He could agree that on the whole the economy had continued to perform well in the period since the 1984 Article IV consultation but that certain matters required the attention of the authorities if their longer-term aims were to be realized.

There were two features of the economic scene in 1985 on which he wished to comment, Mr. Leonard continued: the evolution of the exchange rate, and the operation of the Accord between the Government and the ACTU. The depreciation of the Australian dollar had been an important factor in the overall performance of the economy in 1985 through its effect on domestic prices and the deterioration in the current external account. The depreciation could hardly be attributed to fundamental economic factors as, apart from what seemed to have been an inadequate tightening of monetary policy, several favorable trends had been present: the value and volume of exports had been moving ahead strongly; the Commonwealth budget deficit had been reduced in 1984/85 and was set for further reduction in 1985/86; the total PSBR had continued to diminish relative to GDP; the Accord with ACTU had been successfully extended until 1987 on moderate terms; and unit labor costs had continued to fall steadily, and quite sharply in currency terms, vis-à-vis those of Australia's trading partners.

The staff had suggested that while a wide range of factors had influenced exchange market developments in 1985, underlying market concern about the external current account and debt position had played a significant role, Mr. Leonard noted. It seemed to him that the ultimate source of the market concern must have been the rise in aggregate domestic demand, based largely on monetary expansion, coupled perhaps--though that was a very tentative suggestion--with the significant growth of the operating surplus of corporations. Therefore, he would appreciate an elaboration by the staff of its views on the underlying causes of the depreciation. In particular, he would like to know whether it appeared with hindsight that monetary policy in 1985 might properly have been very much tighter than it had been and whether it might not need to be given a further sharply contractionary twist. He had also been intrigued by the footnote on page 14 of the staff report, indicating that there was a school of opinion that considered that floating of the exchange rate might not have been quite right for Australia and that some other arrangement with a greater element of management might have been better. There was hardly any point in pursuing what was little more than an academic issue at the present juncture, except to follow Mr. Wijnholds' line of thought and suggest that Australia's purist approach to exchange rate policy might be relaxed somewhat.

The Australian Accord still had some appeal to him as a means of securing balanced growth and higher employment, Mr. Leonard remarked. As a policy approach, its pedigree was somewhat outmoded, but it had the touch of the outsider that just might win the race against other more scientifically bred runners. He had been impressed by the moderation in pay awards so far under the Accord, but he agreed with the staff that as unemployment fell and capacity utilization in the economy rose, the circumstances for its continued success became less propitious. However, the authorities seemed clearly aware of the obstacles to be cleared, especially in the form of a combination of indexation and productivity increases, and they were continuing to show great sureness of touch in dealing with the Congress of Trade Unions. As to future negotiations, the possibility of keeping pay increases to necessarily low single figures appeared to depend more on mutual trust and confidence between the parties than on calculations of percentages and figures of, inter alia, unit labor costs and imported inflation. He hoped that the Accord would continue to be marked with success. However, it had to be noted that labor market arrangements characterized by centralized wage setting procedures and a degree of indexation could contribute to rigidities resulting in inefficiencies and risking a renewal of inflation as economic activity strengthened. It would be wise, therefore, for the authorities to endeavor over the medium term to move away from the present regime and to develop more flexible procedures.

Certain specific issues of policy raised in the staff reports needed to be considered in the light of exchange rate developments and the progress of the Accord, Mr. Leonard considered. In the fiscal area, he agreed with the staff that the growth of expenditure had to be restrained, especially as there was a prospective loss of revenue as a result of tax reform. One source of disquiet with the exchange rate would thereby be diminished and the burden carried by monetary policy eased. In the latter respect, the authorities' recent measures to deregulate the financial system were welcome. It was true that those measures had complicated the conduct of monetary policy, a wide range of indicators having to be interpreted in order to establish the appropriate policy stance. Notwithstanding those difficulties, he was in strong agreement with the staff and the Australian authorities that the strength of domestic demand and of credit expansion, the deterioration in the current external account, and the fall in the exchange rate all pointed to the need for firm monetary policy. In the circumstances, the further tightening of policy and the rise in interest rates when the exchange rate had come under renewed pressure had been appropriate. Experience also pointed to the need, along with continued caution in monetary policy, to persist with policies in other areas that improved the competitiveness of the economy and encouraged the reduction of the current account deficit.

In the latter connection, further external adjustment was of major importance, Mr. Leonard commented. He reiterated that downward movements in the exchange rate should not be allowed to result in economy-wide pay increases and subsequent increases in prices. In that respect, the more rapid implementation of measures--including the lowering of protection--to encourage a more competitive, outward looking industrial sector would be highly beneficial.

Mr. Suraisry said that he was in general agreement with the main points in the staff appraisal. It was gratifying to note that the economic recovery in Australia had continued into its third year. In 1984/85, output had grown by about 5 percent, and the unemployment and inflation rates had declined simultaneously. That commendable result had been achieved largely by the authorities' successful mix of incomes, fiscal, and monetary policies. Despite that success, however, some weaknesses remained, particularly in the external sector. In 1985, the balance of payments had come under pressure, the external debt had continued to increase, and the exchange rate had depreciated sharply.

The authorities' objective was still to increase output, reduce inflation, and improve the external position, Mr. Suraisry observed. That objective required them to maintain a delicate balance of policies. In the period ahead, domestic demand needed to be restrained so that resources could be directed toward improving the external sector. The fulfillment of that goal depended to a large measure on the continued success of incomes policy, which needed to remain cautious. To the extent that wage increases compensated for the depreciation of the exchange rate, the impact of the depreciation in directing resources toward improving the external position was likely to be small. In that context, he had been pleased to note that the Accord between the labor unions and the Government allowed for some leeway, although if the depreciation continued, or productivity gains turned out to be below expectations, greater leeway would be needed to realize the full benefit of the depreciation. Mr. Rye's statement had been reassuring in that respect.

In view of the difficult constraints in the Australian labor market, the Accord might be the best possible arrangement over the medium term, Mr. Suraisry remarked. However, wage indexation should remain a temporary solution. Over the long term, as the experience of other countries had shown, wage indexation tended to create rigidities in the labor market, complicate efforts to bring inflation under control, and make the process of resource allocation less efficient. Experience had also shown that wage indexation was difficult to dismantle when it had run its course. Allowing market forces to determine wage levels freely, while at the same time eliminating any shortages or bottlenecks that might develop in the labor market and following appropriate financial policies was a much better course of action in the long run.

Fiscal and monetary policies had been an important component of the authorities' strategy, Mr. Suraisry observed. Following the expansionary fiscal stance that had induced the recovery, the budgetary deficit had been reduced in the past two fiscal years in order to allow room for a noninflationary expansion of the private sector. A number of commendable measures had also been included in the 1986/87 budget. The structure of taxation had been improved, and marginal income tax rates had been reduced, which should improve incentives for investment. However, as the staff had pointed out, the effect of those measures would not be revenue neutral and supplementary reductions in expenditure would be needed. In that context, he welcomed the Government's so-called trilogy of fiscal commitments, aimed at reducing the fiscal deficit and the size of the Government. While the Commonwealth Government had made commendable progress in reducing its deficit, the state governments and enterprises had not. He hoped that the voluntary global limits on borrowing would provide a sufficient framework for fiscal control at the state level.

The conduct of monetary policy had also been commendable, Mr. Suraisry added. As the structural changes brought about by deregulation had made the traditional monetary indicators less reliable, the authorities had made a more general evaluation of the stance of monetary policy. In particular, he welcomed the intention not to loosen their monetary stance unless there were clear signs of slowing demand and improvement in the external accounts.

Externally, the authorities were rightly aiming to increase the competitiveness of Australian industry by exposing it to external competition, Mr. Suraisry said, a particularly noteworthy objective at a time when Australia's exports were being increasingly subjected to protectionist measures. It was important for Australia to continue to liberalize its trade system, but equally important that its exports be allowed access to foreign markets. He had also been pleased to note that the authorities had maintained their overseas development assistance despite the recent fiscal restraint.

In sum, Mr. Suraisry concluded, the authorities had been very successful in the management of their economy. The present situation carried some risks but present policies, with regular reviews and some modifications, seemed appropriate.

Ms. Bush said that, as other Directors had indicated and as had been noted in the staff paper, several favorable trends in Australia had continued in fiscal year 1985, with real economic growth remaining strong, consumer price increases moderating, and unemployment decreasing. At the same time, the current account deficit had widened significantly to some 5 percent of GDP, the overall payments position had moved into deficit for the first time in years, external debt had increased, and the Australian dollar had depreciated throughout 1985, contributing to a re-emergence of inflationary pressures by late in the year. Those latter developments indicated that a cautious policy stance would be appropriate to restore a more favorable external position; indeed, the policy approach of the authorities appeared to address those concerns.

One welcome development was the revival in private investment in the past fiscal year that was expected to continue, although at a slower pace in the current year, Ms. Bush remarked. The very encouraging expectation that business fixed investment would not diminish probably had something to do with improved profitability in the business sector, which could also be contributing to the improved employment situation. Of course, the latter was also related to the decline in unit labor costs with the growth of productivity and with real average wage earnings remaining constant.

Apparently, the Accord between the unions and the Government had been effective in containing wage costs to date, Ms. Bush noted. Her chair, of course, preferred a more market-oriented approach to wage determination although she recognized that such accords had been prompted partly by the strength of union bargaining power in Australia. However, although the Accord seemed to have served a purpose, particularly as recent modifications to the agreement had moved in the direction of maintaining external competitiveness, she hoped that it would be a transitory arrangement because it was not likely to serve the economy well over the long run. The staff paper had highlighted some issues relating to the adjustments to be negotiated following productivity increases and exchange rate changes. Care must be taken to avoid eroding the gains in competitiveness that had followed those changes. In that respect, she noted from Mr. Rye's statement that efforts would be made to contain labor costs. One drawback of a more structural nature to such a system of wage determination related to its intersectoral effects on labor mobility. Specifically, she wondered whether such an arrangement did not limit the normal and, in fact, desirable expansion and contraction over time of various economic sectors since it weakened the signals that wage changes gave to the labor market. She had noted from the staff report that the authorities' fiscal policy was aimed at attempting to make room for the shift of resources to net exports. That goal also appeared to require exchange rate changes and consequent relative price shifts to be reflected in relative wage shifts in order to secure the desired resource reallocation. She would welcome comment by the staff or Mr. Rye on that aspect.

In general, the economic policy approach being taken in the current fiscal year appeared appropriate, Ms. Bush considered. The substantial adjustment embodied in the 1985/86 budget was expected to reduce the deficit to 2.1 percent of GDP and to reduce the total PSBR. The containment of expenditures was particularly welcome. The tax reform that was being implemented contained elements that she viewed as being very helpful to strengthening incentives for savings and investment, including the reductions in the marginal tax rates on personal income. She also endorsed the authorities' trilogy of long-term fiscal goals: containment of expenditures, no increase in tax revenues, and a decrease in the deficit, all as a proportion of GDP.

Monetary policy seemed to be aimed at the containment of excess demand pressures, with interest rates being quite high, although according to the supplement to the staff report, rates had recently declined somewhat, Ms. Bush continued. She would be interested to learn from either the staff or Mr. Rye whether the continued strong demand for credit, even in the face of those interest rate hikes, had anything to do with profitability. In light of exchange market developments and growing inflationary pressures, it might be prudent to maintain a cautious monetary policy in the near term. The deregulation that had occurred in the financial sector, including the decision to permit foreign financial institutions to participate in the local market, was gratifying. Progress in deregulating, and broadening and deepening financial markets should serve Australia well with respect to ensuring appropriate and competitive financing for the growth of investment and commercial activity.

Developments in the exchange market had been somewhat unexpected in 1985, Ms. Bush observed. Apparently, the exchange rate had adjusted sufficiently to restore the basic competitiveness of the traded goods sectors and would lead to an eventual improvement in the current account. Perhaps the increase in exports in January signaled a turnaround, although imports of investment goods remained strong.

She especially welcomed the liberalization of the foreign investment regime in October 1985, which had been detailed in the report on recent economic developments, Ms. Bush remarked. She understood the authorities' concerns relating to foreign ownership but believed that such concerns should not be emphasized to the extent that the desired increases in inflows of equity capital did not materialize. That point was most relevant to the authorities' goals of broadening the productive base of the economy while containing the recently increasing national debt servicing burden. One way in which an accelerated pace of adjustment would be welcome was trade liberalization. An enhanced role for competitive forces could go far toward hastening increases in the efficiency of domestic industries. She was glad to know that the authorities had indicated support for a new round of multilateral trade negotiations.

In conclusion, the Australian economy had shown some enviable trends, with real growth strong and unemployment decreasing, Ms. Bush said. With private sector activity having picked up, the authorities had room to tackle some fiscal issues, thereby perhaps permitting a further strengthening of those trends in the long run. Future developments in Australia would be interesting to follow.

Mr. Lundstrom considered that the Australian authorities should be commended for their determined--and in some ways nontraditional--approach to the difficulties that had faced the economy some years previously. Not only had the chosen strategy resulted in reduced inflation and reduced unemployment, it had also increased investment and raised output. Clearly, those were impressive achievements. His remarks would therefore be concentrated, like those of other Directors, on the emerging problems.

First, it was difficult to estimate the effect of the gradual tightening of monetary policy on the real economy during 1985, mainly because of the changes in the monetary system, Mr. Lundstrom remarked. Although there had been some reduction in the level of interest rates during past months, those rates were still high in real terms, and they might have a detrimental effect on private sector demand for credit and thus on the ability to activate the resources made available by the reduction in public demand.

Second, a main element of the authorities' strategy had been an expansionary stance on fiscal policy, Mr. Lundstrom added. Some adverse effects of that policy--notably on the current account and with respect to inflationary pressures--pointed to the limitations and inherent dangers of the strategy chosen. The authorities were, of course, aware of those risks and had managed to reduce the fiscal deficit of the Commonwealth sector as a percentage of GDP to 3.3 percent for 1984/85; the estimate for 1985/86 was 2.1 percent, and he had been pleased to note from Mr. Rye's statement that it stood a reasonable chance of being achieved. The efforts of the state and local authority sectors, however, seemed to be less successful and would probably have to be strengthened. Even though the incomes policy pursued by the authorities had produced astonishing results, he agreed with the staff that a more determined effort to reduce the total public sector deficit was required.

Third, the rising trend of inflation during the past year was of concern, and he joined the authorities in hoping that it would be reversed, Mr. Lundstrom continued. They still appeared to place very strong emphasis on incomes policy measures in an endeavor that was of considerable interest to other countries and deserved careful evaluation. He commended the staff for its comprehensive analysis of the relationship between prices and the Accord. There were well known dangers with any system of wage indexation, but the discipline on both sides to the Accord seemed sufficiently strong to make it preferable to traditional incomes policy measures, at least in the short term. The Accord strongly influenced the competitive position of the business sector. Although that position--measured in terms of unit labor costs--had improved, the deficit on current account was unsustainably high, and the forecast for 1985/86 had recently been revised upward, although only slightly. That development might be attributable to the J-curve effect but it might also indicate that the stimulatory consequences of fiscal policy had been underestimated. In any event, there seemed to be little doubt that demand pressures remained too strong and that the danger signals pointed out by the staff should be taken seriously by the authorities.

Finally, Mr. Lundstrom said that he welcomed the authorities' pledge to take further steps to gradually relax restrictions and barriers to trade. Admittedly, Australia was facing the trade restrictions of other countries, which was deplorable, but that did not weaken the call for further liberalization as a means of increasing the efficiency of the Australian economy. The performance of Australia with respect to official development assistance compared favorably with that of many other countries, although the prospective decline in the ratio of ODA to GNP in 1985/86 was a matter for concern.

Mr. Yang remarked that the Australian authorities had successfully carried out economic policies which had led the economy into its third year of expansion at an annual rate of 4-5 percent. The rate of unemployment had fallen from its peak of 10 1/2 percent in 1983 to 7.8 percent by the end of 1985; fiscal policy was also headed in the right direction, after having played an expansionary role in initiating the economic recovery. The timely turnaround in the fiscal stance had been conducive to reducing public sector demands on domestic savings. Monetary policy had become more prominent, in that it had helped to contain aggregate demand and keep inflation in check. The prices and incomes Accord had continued to work well, and real unit labor costs had declined further in 1984/85. All those developments indicated that Australia's economy was performing satisfactorily.

The situation in the external sector, however, appeared to be a source of concern, Mr. Yang went on. Current account deficits, which were currently about 5 percent of GDP, were apparently unsustainable. Australia's external indebtedness had reached a level equal to more than 33 percent of GDP. There was little evidence so far that the situation would improve soon, especially in view of rising protectionism and subdued commodity prices. The sizable depreciation of the Australian dollar that was under way might eventually improve the foreign trade performance, but an unwelcome side effect was that it had inevitably put upward pressure on domestic inflation. Therefore, some measures of structural adjustment might make a more fundamental contribution to enhancing the competitiveness of Australian industry. His chair had been pleased to note that the Australian authorities had adopted a number of major industrial plans since 1982, and it might be advisable for the pace of their implementation to be accelerated.

Domestic demand and inflation were other major concerns, Mr. Yang observed. The staff had pointed out at the end of its appraisal that "in the first part of 1985/86, domestic demand was still growing too strongly and although policy has been framed with an eye to slowing it down in the first half of calendar 1986, it is not yet possible to find much evidence that this is occurring." However, the figures relating to domestic demand in Table 1 of the staff report appeared to project a decline in the current year, and the reduction in public demand was fairly substantial. He had also learned from Mr. Rye's statement that recently there had been some emerging signs of deceleration in domestic demand. Bearing all that information in mind, a further assessment of the demand situation might be needed so that an appropriate course of monetary policy could be taken.

With respect to inflation, it was obvious that both excessive demand and the depreciation of the exchange rate had contributed to the increase in prices, Mr. Yang said. But which of those two factors was the major cause for the present inflation remained unclear to him. If inflation was mainly the consequence of exchange rate movements and if domestic demand had truly moved to a downward trend earlier than expected, he would be inclined to support the view that a cautious easing of interest rates might be desirable so that the momentum of economic activity could be consolidated. If that was not the case, he could accept the view of the staff and some other Directors on the need for maintaining tight monetary conditions.

Finally, Mr. Yang said that he trusted that Australia's official development assistance, which had declined slightly relative to GNP in 1985, would eventually increase to meet the UN target of 0.7 percent of GDP.

Mr. Lankester observed that the past year had been a good one in many ways for the Australian economy as the strong recovery had continued, leading to a further reduction in unemployment. GDP had risen by 14 percent since the trough of the recession. That impressive performance owed much to the continued success of the authorities' policies, and in particular the extent to which the prices and incomes Accord had restrained wage and cost increases in the face of a public sector borrowing requirement, which, despite tightening in the previous budget, was still fairly large. Those policies had allowed a strong recovery in output to be combined with an enviable cost performance, a strong recovery in profits, and, at least until recently, falling inflation. Mr. Zecchini had argued that the Australian experiment was of a Keynesian type, as opposed to the British experiment. That might have been true to some extent in the early part of the new Government's term of office, but he had detected a significant change at least over the past year. Monetary discipline was being used much more as a counterinflationary instrument to reinforce the Accord than it had been earlier. And fiscal policy was more cautious, designed as in the United Kingdom to free up resources for the private sector.

Despite the achievements of the Australian authorities, there had been some signs of strain in the economy over the past year, Mr. Lankester continued, first, with respect to the external position. The large current account deficit that had fluctuated about 4-5 percent of GDP in recent years had been associated with a rapid rise in external debt, from 22 percent of GDP in 1982-83 to about 33 percent in June 1985. While a debt burden of that magnitude was not in itself unsustainable, the rapid buildup of debt was a cause for concern and implied that the current account deficit would need to be reduced over the medium term to a more sustainable level. The recent depreciation of the Australian dollar would of course be of potential assistance in that respect. The second area of concern was the rate of inflation, which had been on the increase, partly on account of the depreciation.

The authorities seemed to be well apprised of the risks that developments on those two fronts posed for their strategy, and they had focused their policies accordingly, Mr. Lankester went on. The prices and incomes Accord appeared to have been remarkably successful over the past three years in restraining wage and cost pressures and allowing a strong recovery in profitability. In retrospect, experience in the United Kingdom with such arrangements had not been particularly satisfactory, although it was dangerous to make comparisons. One particular difference between the U.K. experience in the late 1970s and Australia's more recent experience was that the prices and incomes Accord had been in place at a time of rapid growth, which presumably had made the trade unions reasonably content to accept the Accord. But for what it was worth, the outcome in the United Kingdom suggested that agreements of that kind came under increasing strain over time, a point made by the staff in its report. There were likely to be pressures from the demand side of the labor market as employers were tempted to increase wages to attract scarce categories of workers. The depreciation of the Australian dollar in 1985 would put further upward pressure on domestic prices during the course of 1986. According to the staff, the authorities estimated that, other things being equal, the impact in the first half of 1985 would be an increase in prices of about 5 percent. He would be interested to learn from the staff how the overall depreciation during 1985 might be expected to affect the price level and what lags were involved. In any event, it was clear that the effects of the depreciation on inflation in 1986 were likely to be rather higher than the 2 percent reduction in indexation explicitly allowed for in the agreement for the first half of the year. It would be important somehow to restrain wage increases if the effects of the lower exchange rate were not to be dissipated. In that respect, he hoped that the authorities were correct in their view that the required wage adjustment could be achieved through a combination of reduced wage indexation and a deferral and/or modification of the productivity award.

A relatively inflexible system like the Accord was also likely to come under increasing pressure from the growing distortions that it created, Mr. Lankester remarked. Like Mr. Leonard, he hoped that the authorities would be able to move toward a more flexible and responsive system that would more accurately reflect changing supply and demand factors affecting the labor market. The level of unemployment in Australia was not high by international standards, although he understood that it was perceived to be high by the Australian people. The authorities would therefore no doubt want to lower the rate of unemployment; that objective would be reached more easily, it seemed to him, under a more flexible wage system, despite the benefits that had been derived from the Accord.

The authorities' decision to tighten fiscal policy in the August 1985 budget had been appropriate, Mr. Lankester considered, given the pressures on the current account and the need to avoid crowding out private sector activity, which was recovering strongly. The reliance upon expenditure restraint rather than on revenue increases in tightening the fiscal stance was also welcome, particularly following the sharp rises in the volume of public expenditure in preceding years. Obviously, public expenditure was likely to remain under some pressure over the few years ahead. He welcomed the three-part commitment which the Government had announced to reduce public expenditure's share of GDP, and the tax reform, which would lead to reductions in revenue. In that connection, he would have been interested in a fuller discussion in the staff paper of the medium-term outlook for fiscal policy. It would also be useful to know what measures the authorities were considering to reduce expenditure. In seeking to improve the overall fiscal position, the stance of the state and local authorities would be crucial. While the recently introduced system of voluntary global limits on borrowing was a step in the right direction, the ability of the state and local authorities to maintain their activities by running down their reserves emphasized the need for further measures to coordinate policy in that area. The difficulties that could ensue for the overall stance of economic policies, if the lower levels of government went their own way, were all too familiar in the United Kingdom.

The problems faced by the Australian authorities in targeting M3, in the face of distortions created by financial deregulation, were understandable, Mr. Lankester remarked. He fully supported their decision to monitor a range of indicators, including the exchange rate, in judging the appropriateness of the monetary stance. The recent reduction in interest rates was timely, following the high level of real rates that had prevailed at the end of 1985. As Mr. Rye had recognized, however, a cautious monetary policy would have to be maintained in the months ahead, given the continuing upward pressures on inflation. Although the process of deregulation seemed to have resulted in some difficulties in the day-to-day operation of monetary policy, it should have significant benefits in promoting a flexible and competitive financial sector. In that connection, he fully endorsed the moves made by the authorities away from quantitative controls on the financial sector toward a more market-oriented system.

As for external policies, Mr. Lankester said that he strongly supported the authorities' intention to encourage the manufacturing sector to turn its attention to exports, partly by reducing the protection afforded to domestic industry. In that connection, the recommendation of the Industry Assistance Commission that existing tariff quota assistance be phased out gradually seemed appropriate, although he wondered whether a rather more rapid adjustment than the seven-year period starting in 1989 might not be considered.

In conclusion, Mr. Lankester said that while he had noted some of the risks and uncertainties associated with the current stance of policies, he wished to commend the authorities for their success in promoting strong growth in recent years and for the important structural reforms they had initiated in various fields, particularly in the financial sector.

Mr. Archibong observed that for the third consecutive year, the Australian economy had shown buoyant growth with strong expansion in economic activity. Overall growth in real gross domestic product, which had risen by 4.8 percent in 1984/85, was expected to accelerate to 5.7 percent in 1985/86. The fact that the economy had recorded a negative growth of 0.6 percent barely three years previously, in 1982/83, reflected in large part the high degree of success of the authorities' overall economic strategy in coping with existing problems.

From the indicators presented by the staff, the short-term prospects seemed generally favorable, Mr. Archibong added. Both consumption and investment were expected to rise, propelled by strong growth in employment and gains in competitiveness due to the depreciation of the Australian dollar, which was encouraging greater investment in tradeable goods industries. Although recent developments suggested faster growth in real exports of goods and services--projected at 4.5 percent for 1985/86--the continued marked deterioration in the terms of trade, which reflected the weakness in world commodity prices, and higher than expected import volumes made the outlook for the current deficit unfavorable. He hoped that current fiscal and monetary policy would have the required response, reducing domestic demand, enhancing competitiveness, and consequently narrowing the deficit on current account.

The authorities' concern about the possible adverse consequences of an excessive rate of increase in domestic demand appeared to have been the main factor influencing the stance of monetary policy, Mr. Archibong noted. The tight monetary conditions, based largely on high levels of interest rates, could moderate domestic demand and the inflationary impact, assuming strong interest rate sensitivities. However, one concern that he shared with the staff was the possibility of adverse effects on economic activity if the current high levels of interest rates were sustained for a considerable period. In that event, the Australian authorities might be confronted with a serious problem of how to achieve a satisfactory rate of growth of output and employment over time while simultaneously controlling domestic demand and inflation. A cautious trade-off would be required, and the authorities might wish to be careful not to discourage investment unduly; otherwise, the benefits of improved competitiveness could be eroded. Equally, they should avoid any action that could abort the existing wage restraint. Hence the decline in real labor costs was an important factor in the growing profitability of business.

The success achieved so far by the prices and incomes Accord between the Government and the trade unions was noteworthy for two reasons, Mr. Archibong considered. First, according to Mr. Rye's statement, the Accord was regarded as the cornerstone of the Government's macroeconomic policy. Among other things, wage restraint, the resulting relatively low labor costs, and the growing profitability were largely attributable to the Accord. Second, the success of the Accord showed that, under certain economic circumstances, a policy that was not based on full exposure to market forces could work. According to the staff, the Accord had, generally speaking, continued to work well. In the Australian labor market, with its powerful and aggressive trade unions, wages could move up excessively, particularly in periods of economic expansion, in the absence of such an Accord, making it extremely difficult to sustain competitiveness.

Australian official development assistance, at 0.50 percent of GNP in 1984/85, had fallen slightly from 0.51 percent in the previous year, Mr. Archibong noted. While commending the authorities for the generous aid they had been extending to developing countries, he regretted the slight cutback and urged them to aim at raising their contribution, particularly during a period when foreign earnings of developing countries, as well as capital flows to those countries, had been declining steeply.

Mr. Salinas said that as had already been indicated, the economic performance of Australia during 1985 had been characterized by significant achievements in the areas of growth and employment, as well as by the ability of the economy to reduce labor costs by means of increased labor productivity. In addition, the prices and incomes Accord, which remained a cornerstone of macroeconomic policy, seemed so far to have had the expected results, with wages and salaries moving in a manner that had contributed to a moderation of the growth of labor costs.

Notwithstanding those commendable developments, the current and future prospects of the Australian economy were clouded by a number of uncertainties, Mr. Salinas continued. Indeed, as noted by the Executive Board during the 1984 Article IV consultation with Australia, the recovery in activity had led to a combined revival of pressures on prices as well on the external accounts. Price developments during 1985 reflected not only the sharp depreciation of the dollar but higher levels of capacity utilization, which might be starting to reduce the ability of the economy to respond to additional demand pressures. Moreover, and even taking account of the contribution of the Accord in slowing somewhat the growth of labor costs, it was still evident that the current mechanism for adjusting wages and salaries posed an additional and significant amount of pressure on the behavior of prices, which threatened the achievement of a more balanced external position. Indeed, the increased current account deficit in 1985 was beginning to be a matter of concern, given both the level of external debt and its upward trend throughout the past few years. To that extent, a reduction in Australia's reliance on foreign capital through the promotion of higher levels of domestic savings seemed to be necessary in the years ahead in order to finance economic growth on a more sustainable basis and avoid the risk of a further deterioration of the current account.

On fiscal policy, he agreed with the authorities' approach of a gradual reduction of the fiscal deficit as a percentage of GDP by means of further reductions in expenditures while keeping tax revenues mostly unchanged or even reducing them so that private investment and savings could be encouraged, Mr. Salinas commented. The need to correct the external imbalance and to prevent the re-emergence of inflationary pressures had reduced the room for maneuver in the fiscal area, emphasizing the need for continuing efforts to reduce the fiscal deficit.

On the issue of protectionism, he concurred with the views expressed by Mr. Jaafar, Mr. Salinas remarked--namely, that Australia was suffering the pervasive effects of protectionism, in the form of the barriers faced both by its exports and by those that the country had been imposing on a number of items. Far from contributing to the aims of sustainable economic growth and financial stability, the result was inefficient resource allocation and unnecessary further distortions, which usually proved quite difficult to overcome. The competitiveness of Australian exports and the efficiency of import substitution industries could be better achieved through an appropriate exchange rate and by keeping domestic demand in line with the objectives of external and internal equilibrium. A cautious monetary policy, together with the projected further reductions in the fiscal deficit, would certainly contribute to that end. However, additional adjustments were needed in the area of prices and incomes. A clear link between the adjustment of wages and productivity increases would be a reasonable starting point for defining the scope and magnitude of income compensation, without risking the attainment of lower levels of inflation or eroding Australia's competitiveness.

The Deputy Director of the European Department noted that when the staff had begun the consultation discussions with the Australian authorities, it had been faced with the rather unusual situation of a country following a policy of trying simultaneously to achieve fast economic growth, keep inflation down, and make a fairly large external adjustment. But it had also been faced with a set of policies that seemed to be admirably well conceived: a tight fiscal policy, a tight monetary policy, and an effective policy for keeping costs under control. He wondered whether some Directors had not been too severe in their comments: one particularly successful aspect of the policies was the growth of employment, which according to the latest available figures was likely to be close to 10 percent in the three years ending April 1986.

The Australian authorities regarded 1985 as a year of learning to operate monetary policy in a deregulated environment, the Deputy Director continued. That was obviously a challenge for any monetary authority, and the Australian authorities had been modest in the description of their own efforts. They would also agree with the staff, with the benefit of hindsight, that monetary policy in the course of 1985 should have been tighter. The movement of the monetary aggregates had been hard for both the authorities and the staff to understand, yet it was imperative to decelerate the rate of expansion of the aggregates. However, the suspension of monetary targets should not be overemphasized. As noted in the staff report, the authorities had indicated that they would feel more comfortable if broad money growth fell by a couple of percentage points. Therefore, the absence of a specific monetary target should not be taken to mean that monetary aggregates were not closely watched; they were, as were interest rates.

While high interest rates did not necessarily indicate tight monetary policy, since the strength of inflationary expectations also mattered, the staff judged that the high level of interest rates in Australia at present did indeed signify a tight stance, the Deputy Director stated. First of all, although the rate of inflation had accelerated, it had done so quite modestly, and there did not seem to be a general fear in the market of some further sudden acceleration. Second, short-term interest rates had risen much more than long-term interest rates; if inflationary expectations were at the root of the matter, it seemed likely that long-term rates would have moved more. Third, as could be seen from the supplementary staff report, the monetary aggregates were growing more slowly in recent months, suggesting that monetary policy had begun to bite. The fall in interest rates in the past month or two had certainly not been engineered by the authorities. It could perhaps be described more accurately as a market-induced move, which the authorities had accepted.

He had little to add to what was said on page 10 of the staff report on the causes of reintermediation, the Deputy Director remarked. The struggle of all the financial institutions under deregulation to enlarge their share of the business had led to all sorts of shifts between nonbanks and banks, to the point that even foreign banks were entering the fray. In terms of the effects on the monetary aggregates, it was also important not to overlook the point that what had previously been direct credit--for instance, between enterprises--was tending to be channeled through financial intermediaries.

Although it would be difficult to prove statistically, the continuing strength of credit expansion, in the face of increased interest rates, was almost certainly due in part to the deregulation of the financial system, the Deputy Director considered. In short, deregulation had enlarged both sides of the financial institutions' balance sheets. In addition, if all nonprice rationing of credit was stopped, higher interest rates would presumably be needed in order to secure a given degree of restraint. Finally, he thought that whenever an economy was growing as strongly as the Australian economy had been throughout 1985, high interest rates tended to be accepted with surprisingly little resistance.

As to the relationship between monetary policy, inflation, and depreciation, the Deputy Director noted, the rate of inflation had increased from end-1984, when it had been about 5 percent, to 8 percent at end-1985. As noted in Mr. Rye's statement and in the staff report, depreciation accounted for two of those three percentage points; the third point could be described as domestically induced. Indeed, it would be surprising if, in a year of such strong demand, there were not some upward pressure on the price level.

As mentioned in the report on recent economic developments, a comprehensive White Paper had been issued on tax reform in June 1985, and discussed at a National Taxation Summit in the following month, the Deputy Director noted. While the preferred option of the Government in the draft White Paper had been an ambitious proposal to introduce a broadly based consumption tax, the necessary degree of support for its enactment had not been forthcoming. The business community had taken a more negative attitude than had been expected, and a number of social groups had voiced opposition on the grounds that the tax was regressive. The Australian authorities had taken the view that many people had failed to understand the Government's intention to compensate low-income groups in particular for the effects on their living standards of the tax, which would have been at a rate of 12.5 percent and would have increased prices by 6.5 percent. It was the third time within a decade that Australia had tried without success to introduce such a tax, which was still supported in principle by the Government.

While the reduction in the budget deficit in 1984/85 had been mainly cyclical, the fall in the current fiscal year was largely structural, the Deputy Director explained. Although the Australian authorities would surely agree with Directors that it was necessary to bring the budget and the borrowings of the states under control, there was a constitutional limit on the Commonwealth's authority. The trilogy, which applied only to the Commonwealth budget and not to that of the whole public sector, was an attempt to promote a medium-term fiscal policy which could be described simply as reducing the deficit by controlling expenditure. He had no information at present on what measures would be taken to that end.

Employers in Australia belonged to several federations rather than to a single organization, which made it difficult to include employers in the Accord, the Deputy Director remarked. Another impediment to the participation of employers was that they were firmly on record as being opposed to the indexation of wages. An important element in the durability of the Accord was the quality of the ACTU, which had enlightened and persuasive leaders.

As Mr. Zecchini had observed from Chart 2 in SM/86/26, the lag with which wages were indexed had certain implications for the evolution of real wage earnings, which could not be avoided by changing the indexation lag, the Deputy Director observed. He also agreed with Mr. Zecchini, as no doubt the Australian authorities would, that what was needed was to limit the increase in real wages to productivity gains; but how to achieve that operationally was a difficult question to answer. A more flexible wage system, and some provision for intersectoral wage shifts, would be desirable but again there were practical problems to be resolved. In earlier years, if one union was awarded a wage increase, all unions submitted requests for equal wage increases to the Arbitration Commission, on the grounds of comparable wage justice. The result had been a wage explosion. The present Government had taken the considered view that, undesirable as the Accord might be, it was wiser to accept it in order to attain overall cost restraint.

It had perhaps been misleading to refer on page 13 of the staff report to the question whether the exchange rate might have been overshot in the short run, the Deputy Director commented. The depreciation that had taken place in the first half of 1985 had been accepted without question by the Australian authorities, but they had been taken aback by the further sharp depreciation in November, which was when references to overshooting had begun to be made. As revealed in subsequent actions, policy appeared to be geared to keeping the rate stable in terms of the trade weighted index, which had been at 64 in the middle of 1985 and was at present about 60. However, that should not be taken to imply that the authorities had in mind a target of any kind. Certainly, as Mr. Zecchini had said, the real exchange rate should not be allowed to appreciate; firmer control of inflation was the way to achieve that objective, which raised once more the issue of policy in general, including monetary and wage policies.

With floating rates, the causes of exchange rate depreciation were never easy to predict, the Deputy Director remarked. But looking back, it could be said that the current account deficit and worries about external debt had certainly played a role, as had certain political factors to which reference had been made in the staff report. There had also been fears that the rise in aggregate demand and in the monetary aggregates would be too great. The footnote on page 14 of the staff report, to which Mr. Leonard had referred, had not been intended to suggest that the Australian authorities were thinking of reverting to another type of exchange rate arrangement. The staff had meant simply to note that with a floating rate, particularly one that had been floating for only about 18 months, market participants were less sure than they had been previously that any given movement would be sustained.

The total effect of the depreciation on prices would probably exceed 5 percent, perhaps by at least 1 percentage point, on the assumption that the exchange rate did not change any further, the Deputy Director considered. It was very difficult to predict how long it would take for that effect to pass through the system. As a matter of fact, one surprising indication of the strength of Australian monetary policy was the extent to which exporters and importers had absorbed the devaluation rather than raising their prices to the full amount.

Ms. Bush explained that her comment about intersectoral wage shifts had been related to labor mobility. A system of wage determination like that of Australia could definitely limit labor mobility because it stood in the way of wage differentiation. Signals about developments in various sectors of the economy were not transmitted into wages.

The Deputy Director of the European Department agreed that one disadvantage of the system was that it tended to perpetuate rigid wage elasticities which in turn inhibited labor mobility.

Mr. Zecchini remarked that he agreed fully with the Deputy Director that the most appropriate way to avoid an appreciation of the real exchange rate for the current year was to tackle inflation. However, he had been referring specifically to another side of the same issue, namely, the possibility of a further depreciation of the nominal exchange rate. The authorities should keep some room for intervention in the exchange market in order to avoid an appreciation of the real exchange rate as a result either of the appreciation of the nominal rate or the inflation differential. He had in mind the results of the Plaza agreement. However, he had noticed that the Australian authorities themselves had pursued a policy of intervening in the foreign exchange market in 1985.

The Deputy Director of the European Department responded that the Australian authorities had intervened for purposes of testing and smoothing, and to a greater extent than in the previous year, because there had been a very sharp fall in the rate.

Mr. Rye remarked that he understood the concerns expressed by some Directors about Australia's prospects and policies, and he was also grateful for the expressions of support and commendation for the achievements of his authorities.

Referring first to the prices and incomes Accord, Mr. Rye noted that among the reasons why employers were not a party to the Accord was that it had been brought into being when the present Government had been in opposition. It would have been inconceivable at that stage for employers, who were naturally more aligned with the then-governing party, to have participated in a scheme devised by a labor party with close links to the trade union movement. As the Deputy Director of the European Department had observed, employers were fragmented in Australia, their commonality of interest not being great; for instance, there were employers in some highly protected sectors of manufacturing and employers in other industries, such as the mining industry, which competed largely on their merits in world markets. However, the machinery for consultation between the Government and employers was quite extensive. A number of committees met regularly, and tripartite consultations took place between the Government, employers, and trade unions.

It was also worth noting that the Accord had been conceived of as an attempt to make an existing system work better, Mr. Rye added. The origins of the arbitration system went back almost to the establishment of the Federation of Australia, it having been in existence for almost 80 years. The only government that had attempted to abolish the system, 50 years previously, had been promptly thrown out of office by the electors. However, the growing debate about whether or not it was a sensible system for determining wages was a healthy development. Increasing attention was being paid to those who preferred a much more market-oriented system. To illustrate the point, much scorn had been heaped on the report of a committee set up by the previous government--a report that had praised the system and recommended its preservation. Meanwhile, the present Government had taken the view that as long as the system existed, it should be made to work more effectively than it had in the past. Years of strong growth--at least in the period since 1970--had inevitably led to the kind of wage breakout that the Accord was an attempt to forestall. When the broad macroeconomic issues relating to the fight against inflation and the prevention of such wage breakouts had faded more into the background, the debate about the Accord would no doubt intensify since its relative inflexibility did impose certain limitations in the longer run that would bring it increasingly under strain. For the time being, the Accord was achieving its objectives with considerable success.

The very sharp easing in the monetary aggregates in the past month or two, projected over the full year, would lead to a rate of growth in small single figures, Mr. Rye remarked. There was some concern, which increased as time went on, about the adverse implications if that trend continued for too long in an economy that was subject to some degree of slowdown. Only the future would show how far that slowdown would go.

The task of maintaining fiscal restraint and further reducing the budget deficit would become more and more difficult, as Mr. Grosche and Mr. Lankester had suggested, Mr. Rye added. It was always easier for a new government to cut into the programs of its predecessor than it was, after two or three years in office, for it to begin to cut into programs that were at the center of its own priorities. Nevertheless, the Government was aware of the problem, and the relevant ministers were giving high priority to determined discussions of the objectives and how to achieve them. It was too soon to be specific about where the cuts would be made; final decisions on the budget were not taken until early July, and the budget was not brought down until August.

External policy had been covered by the Deputy Director of the European Department, Mr. Rye noted. On trade policy, it could not be said that the level of protection of Australia's economy was high across the board. Although the average level of protection appeared high, by comparison with that in other industrial countries, actual protection was heavily concentrated--and at very high rates--in a few industries, of which textiles, clothing, footwear, and motor vehicles, were by far the most important. Elsewhere in manufacturing, rates were on a par with those in other industrial countries. A speeding up of the process of liberalization might well be desirable, but it was only fair to observe that the Government of Australia had, for the first time, put firm programs into effect for reducing the high levels of protection in certain industries over a fixed period of years. The record on that matter was clear, and he would be willing to supply further information on the subject.

Finally, it hardly seemed necessary for him to dwell on the barriers to trade that Australia faced, Mr. Rye commented. Suffice it to say that Australia could not be classified as an industrial country in that respect. The structure of Australian exports was more akin to that of typical developing countries: 80 percent of exports were commodities--agricultural or mineral--and only 20 percent manufactured goods. Just like developing countries, Australia was adversely affected by the protectionist policies of other countries and by low commodity prices.

In conclusion, Mr. Rye said that he would convey a full account of the discussion to his authorities.

The Chairman made the following summing up:

Directors noted with satisfaction that Australia's economic policies had generally been in line with the Executive Board's recommendations on the occasion of the 1984 Article IV consultation. The Australian economy, they pointed out, had continued to perform well during 1985 and was into the third year of a strong expansion; the gains in employment throughout the recovery had been among the largest in industrial countries. Unemployment, though still historically high, had fallen appreciably in the last two and a half years or so.

Directors also pointed, however, to a number of problems which became evident in the course of 1985. The current account deficit of the balance of payments, which had been relatively large in recent years and had attracted some attention in the 1984 consultation, increased to 5 percent of GDP in 1984/85. A deficit of that size was not regarded as sustainable. They also drew attention to the upward pressure on domestic prices which in the twelve months ended December 1985 had risen by over 8 percent, largely as a result of the depreciation of the exchange rate.

Directors made a number of comments on the economic strategy of the Government which combines firm financial policies with a particular form of prices and incomes policy, and a variety of measures to promote a more efficient allocation of resources. Many Directors noted that the "Prices and Incomes Accord" had continued to be effective in containing the overall increase in costs, so helping to foster a needed restoration of corporate profitability. They were nevertheless concerned that, with activity still rising strongly, the Accord would come under increasing pressure. They also questioned whether there was sufficient flexibility in the Accord to prevent the increase in prices due to the depreciation from spilling over into wage increases, and urged the Australian authorities to consider ways in which wages could be fully insulated from the effect of the depreciation on domestic prices. A number of Directors also pointed to the shortcomings of wage indexation and to the rigidities inherent in any centralized adjustment of wages on a nationwide scale. A number of Directors encouraged the authorities to take action to increase the flexibility of the labor market and to shift gradually to a more market-oriented approach to wage determination. Many Directors urged more determined efforts to reduce the protection afforded to domestic industries--including a faster phasing out of tariff quotas than presently envisaged--in order to improve resource allocation and to help dampen wage and price inflation. At the same time, the hindrances to access for Australian products abroad were deplored.

Directors generally complimented the Government on its success in reducing the Commonwealth budget deficit to a level which is projected to be equal to about 2 percent of GDP in 1985/86, and they referred in particular to the successful effort in the last budget to hold down the growth of public expenditure. They welcomed the "trilogy" commitments as a comprehensive fiscal discipline. At the same time, however, they took the view that the borrowing requirement of the whole public sector should be further reduced, particularly since state and local governments now account for more than half the total PSBR. The reform of the tax system that was recently introduced was generally welcomed.

Directors, noting the far-reaching measures of financial deregulation in recent years, noted the reasons for suspending the monetary target in January 1985, although several believed that more emphasis should be given to monetary targeting. Directors welcomed the fact that monetary policy had been substantially tightened during the course of the year. While conceding the difficulty of assessing the degree of monetary stringency in current circumstances, Directors generally welcomed the recent evidence of deceleration in the rate of growth of the monetary aggregates, and hoped that the growth would slow down further in the period ahead. They urged that monetary policy not be relaxed prematurely, particularly because domestic demand still appeared to be growing strongly in the last six months of 1985 and the exchange market still seemed to be in a state of some uncertainty. In that context, Directors noted the authorities' view that the recent downward trend in interest rates was a response to the easing of demand for credit and should not be seen as a relaxation of the policy stance.

Directors stressed the need for external adjustment especially in view of the rapid rise in external debt in recent years to a level of over 33 percent of GDP. In this connection they noted that the competitive position had been improved by the large depreciation of the Australian dollar during 1985--about 25 percent in effective terms--and underlined the importance of avoiding the erosion of that improvement through too large wage increases. They also stressed that external adjustment would require firm control of the growth of domestic demand. Some speakers further emphasized the need to narrow down quickly the inflation differential between Australia and its trading partner countries. The recent liberalization of the foreign investment regime was welcomed.

Several Directors encouraged the authorities to maintain a high priority for official development assistance; some disappointment was expressed at the fall of official development assistance projected for 1985/86.

It is recommended that the next Article IV consultation with Australia take place on the standard 12-month cycle.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/86/40 (3/3/86) and EBM/86/41 (3/7/86).

3. MALDIVES - 1985 ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to extend the period for completing the 1985 Article IV consultation with Maldives to not later than March 19, 1986. (EBD/86/61, 3/5/86)

Decision No. 8213-(86/41), adopted
March 6, 1986

4. VENEZUELA - INQUIRY UNDER ARTICLE VIII, SECTION 2(b)

The Director of the Legal Department is authorized to transmit the letter contained in Attachment C to EBD/86/55 (2/28/86).

Decision No. 8214-(86/41), adopted
March 4, 1986

5. MANAGING DIRECTOR - SALARY - GOVERNORS' VOTE

The Executive Board approves the report of the Secretary (EBAP/86/21, Sup. 2, 3/3/86) on the canvass of votes of the Governors on Resolution No. 41-1, with respect to the salary of the Managing Director, approved by the Executive Board (EBM/86/10, 1/23/86) for submission to the Board of Governors. The Governors' vote on the Resolution is recorded as follows:

Total affirmative votes		893,812
Total negative votes		0
Total votes cast		893,812
Abstentions recorded	1,037	
Other replies	0	
Total replies		894,849
Votes of members that did not reply		35,451
Total votes of members		930,300

Decision No. 8215-(86/41), adopted March 3, 1986

6. ARGENTINA - TECHNICAL ASSISTANCE

In response to a request from the Argentine authorities for technical assistance to review and evaluate the system of tax incentives, the Executive Board approves the proposal set forth in EBD/86/50 (2/25/86).

Adopted March 3, 1986

7. PEOPLE'S REPUBLIC OF THE CONGO - TECHNICAL ASSISTANCE

In response to a request from the Congolese authorities for technical assistance in formulating a tax reform action program, the Executive Board approves the proposal set forth in EBD/86/51 (2/28/86).

Adopted March 5, 1986

developing countries: 80 percent of exports were commodities--agricultural or mineral--and only 20 percent manufactured goods. Just like developing countries, Australia was adversely affected by the protectionist policies of other countries and by low commodity prices.

In conclusion, Mr. Rye said that he would convey a full account of the discussion to his authorities.

The Chairman made the following summing up:

Directors noted with satisfaction that Australia's economic policies had generally been in line with the Executive Board's recommendations on the occasion of the 1984 Article IV consultation. The Australian economy, they pointed out, had continued to perform well during 1985 and was into the third year of a strong expansion; the gains in employment throughout the recovery had been among the largest in industrial countries. Unemployment, though still historically high, had fallen appreciably in the last two and a half years or so.

Directors also pointed, however, to a number of problems which became evident in the course of 1985. The current account deficit of the balance of payments, which had been relatively large in recent years and had attracted some attention in the 1984 consultation, increased to 5 percent of GDP in 1984/85. A deficit of that size was not regarded as sustainable. They also drew attention to the upward pressure on domestic prices which in the twelve months ended December 1985 had risen by over 8 percent, largely as a result of the depreciation of the exchange rate.

Directors made a number of comments on the economic strategy of the Government which combines firm financial policies with a particular form of prices and incomes policy, and a variety of measures to promote a more efficient allocation of resources. Many Directors noted that the "Prices and Incomes Accord" had continued to be effective in containing the overall increase in costs, so helping to foster a needed restoration of corporate profitability. They were nevertheless concerned that, with activity still rising strongly, the Accord would come under increasing pressure. They also questioned whether there was sufficient flexibility in the Accord to prevent the increase in prices due to the depreciation from spilling over into wage increases, and urged the Australian authorities to consider ways in which wages could be fully insulated from the effect of the depreciation on domestic prices. A number of Directors also pointed to the shortcomings of wage indexation and to the rigidities inherent in any centralized adjustment of wages on a nationwide scale. A number of Directors encouraged the authorities to take action to increase the flexibility of the labor market and to shift gradually to a more market-oriented approach to wage determination. Many Directors urged more determined efforts to reduce the protection afforded to domestic industries--including a faster phasing out of tariff quotas than presently envisaged--in order to improve resource allocation and to help dampen wage and price inflation. At the same time, the hindrances to access for Australian products abroad were deplored.

Directors generally complimented the Government on its success in reducing the Commonwealth budget deficit to a level which is projected to be equal to about 2 percent of GDP in 1985/86, and they referred in particular to the successful effort in the last budget to hold down the growth of public expenditure. They welcomed the "trilogy" commitments as a comprehensive fiscal discipline. At the same time, however, they took the view that the borrowing requirement of the whole public sector should be further reduced, particularly since state and local governments now account for more than half the total PSBR. The reform of the tax system that was recently introduced was generally welcomed.

Directors, noting the far-reaching measures of financial deregulation in recent years, noted the reasons for suspending the monetary target in January 1985, although several believed that more emphasis should be given to monetary targeting. Directors welcomed the fact that monetary policy had been substantially tightened during the course of the year. While conceding the difficulty of assessing the degree of monetary stringency in current circumstances, Directors generally welcomed the recent evidence of deceleration in the rate of growth of the monetary aggregates, and hoped that the growth would slow down further in the period ahead. They urged that monetary policy not be relaxed prematurely, particularly because domestic demand still appeared to be growing strongly in the last six months of 1985 and the exchange market still seemed to be in a state of some uncertainty. In that context, Directors noted the authorities' view that the recent downward trend in interest rates was a response to the easing of demand for credit and should not be seen as a relaxation of the policy stance.

Directors stressed the need for external adjustment especially in view of the rapid rise in external debt in recent years to a level of over 33 percent of GDP. In this connection they noted that the competitive position had been improved by the large depreciation of the Australian dollar during 1985--about 25 percent in effective terms--and underlined the importance of avoiding the erosion of that improvement through too large wage increases. They also stressed that external adjustment would require firm control of the growth of domestic demand. Some speakers further emphasized the need to narrow down quickly the inflation differential between Australia and its trading partner countries. The recent liberalization of the foreign investment regime was welcomed.

Several Directors encouraged the authorities to maintain a high priority for official development assistance; some disappointment was expressed at the fall of official development assistance projected for 1985/86.

It is recommended that the next Article IV consultation with Australia take place on the standard 12-month cycle.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/86/40 (3/3/86) and EBM/86/41 (3/7/86).

3. MALDIVES - 1985 ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to extend the period for completing the 1985 Article IV consultation with Maldives to not later than March 19, 1986. (EBD/86/61, 3/5/86)

Decision No. 8213-(86/41), adopted
March 6, 1986

4. VENEZUELA - INQUIRY UNDER ARTICLE VIII, SECTION 2(b)

The Director of the Legal Department is authorized to transmit the letter contained in Attachment C to EBD/86/55 (2/28/86).

Decision No. 8214-(86/41), adopted
March 4, 1986

5. MANAGING DIRECTOR - SALARY - GOVERNORS' VOTE

The Executive Board approves the report of the Secretary (EBAP/86/21, Sup. 2, 3/3/86) on the canvass of votes of the Governors on Resolution No. 41-1, with respect to the salary of the Managing Director, approved by the Executive Board (EBM/86/10, 1/23/86) for submission to the Board of Governors. The Governors' vote on the Resolution is recorded as follows:

Total affirmative votes		893,812
Total negative votes		0
Total votes cast		893,812
Abstentions recorded	1,037	
Other replies	0	
Total replies		894,849
Votes of members that did not reply		35,451
Total votes of members		930,300

Decision No. 8215-(86/41), adopted
March 3, 1986

6. ARGENTINA - TECHNICAL ASSISTANCE

In response to a request from the Argentine authorities for technical assistance to review and evaluate the system of tax incentives, the Executive Board approves the proposal set forth in EBD/86/50 (2/25/86).

Adopted March 3, 1986

7. PEOPLE'S REPUBLIC OF THE CONGO - TECHNICAL ASSISTANCE

In response to a request from the Congolese authorities for technical assistance in formulating a tax reform action program, the Executive Board approves the proposal set forth in EBD/86/51 (2/28/86).

Adopted March 5, 1986

8. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 85/76 through 85/80 are approved. (EBD/86/49, 2/26/86)

Adopted March 4, 1986

9. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/86/50 (3/3/86) and EBAP/86/52 (3/4/86) and by Advisors to Executive Directors as set forth in EBAP/86/13, Supplement 1 (2/28/86) and EBAP/86/52 (3/4/86) is approved.

APPROVED: October 29, 1986

LEO VAN HOUTVEN
Secretary