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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/25

10:00 a.m., February 20, 1985

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

Executive Directors	Alternate Executive Directors
A. Alfidja	
	M. K. Bush
	D. C. Templeman, Temporary
	H. G. Schneider
B. de Maulde	X. Blandin
M. Finaish	T. Alhaimus
H. Fujino	M. Sugita
G. Grosche	B. Goos
	Jaafar A.
	L. Leonard
A. Kafka	C. Robalino
H. Lundstrom	
E. I. M. Mtei	A. Abdallah
	B. Jensen
	J. E. Suraisry
P. Pérez	
	J. de Beaufort Wijnholds
C. R. Rye	A. V. Romuáldez
G. Salehkhou	
A. K. Sengupta	
	T. A. Clark
S. Zecchini	
Zhang Z.	

J. W. Lang, Jr., Acting Secretary
S. J. Fennell, Assistant

Also Present

European Department: L. A. Whittome, Counsellor and Director; B. Rose, Deputy Director; M. T. Hadjimichael, R. P. Hicks, R. Johnson, S. M. Thakur. Exchange and Trade Relations Department: C. D. Finch, Director; M. Guitián, Deputy Director; E. H. Brau, B. de Schaetzen, S. Kanesa-Thasan, A. B. Petersen. External Relations Department: H. O. Hartmann. Fiscal Affairs Department: G. Blöndal. IMF Institute: S. El-Khouri; N. Mouzannar, Participant. Legal Department: G. P. Nicoletopoulos, Director; W. E. Holder, A. O. Liuksila, S. A. Silard, J. V. Surr. Middle Eastern Department: A. S. Shaalan, Director; G. T. Abed, F. Drees, R. H. Floyd, S. H. Hitti, B. A. Karamali, B. K. Short, M. Yaqub. Secretary's Department: A. P. Bhagwat. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer. Western Hemisphere Department: S. T. Beza, Associate Director; T. M. Reichmann. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: A. A. Agah, D. Hammann, K. A. Hansen, H.-S. Lee, G. E. L. Nguyen, J.-C. Obame, G. W. K. Pickering, T. Sirivedhin, A. Steinberg, E. M. Taha, A. Vasudevan. Assistants to Executive Directors: J. R. N. Almeida, I. Angeloni, M. B. Chatah, Chen J., J. de la Herrán, J. J. Dreizzen, G. D. Hodgson, Z. b. Ismail, S. Kolb, M. Lundsager, K. Murakami, A. Mustafa, E. Olsen, J. Reddy, D. J. Robinson, C. A. Salinas, A. J. Tregilgas, A. H. van Ee, A. Yasseri.

1. EXECUTIVE DIRECTOR

The Chairman welcomed Mr. Rye, Executive Director, to the Executive Board.

2. BRAZIL - EXTENDED ARRANGEMENT

The Managing Director noted that the staff report for the third review under the extended arrangement with Brazil (EBS/85/37, 2/14/85) had recently been issued. The report described the country's recent economic performance, which although strong on the external side, had been weak with respect to inflation; summarized the adjustment program that had been developed for 1985; and explained deviations from the projected path subsequent to the discussions on the 1985 program. Those deviations, which had been particularly large in the monetary area, had necessitated a reappraisal of Brazil's situation and were likely to preclude presentation of the adjustment program to the Executive Board in the timeframe originally envisaged.

The staff was working with the Brazilian authorities to re-establish a program, the Managing Director commented. A team of Brazilian technicians was currently in Washington for the necessary discussions. He had informed the banking community of recent developments in Brazil and had urged them to maintain their existing financing arrangements with the country.

3. LEBANON - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with Lebanon (SM/85/9, 1/7/85). They also had before them a report on recent economic developments in Lebanon (SM/85/34, 2/4/85).

Mr. Finaish made the following statement:

> Since the mid-1970s the Lebanese economy has been operating under extremely difficult conditions characterized by a lack of security as well as social and political instability. The persistence of these conditions has led to a marked erosion of the economic and physical infrastructure of the country which is reflected in a substantial decline in most areas of economic activity. Until 1982, however, the effects of these adverse conditions were mitigated by a remarkable show of confidence on the part of the private sector in the ability of the Lebanese economy to recover quickly once the security situation was settled. This confidence was reflected in a steady flow of remittances in excess of the consumption needs of workers' families, and intermittent rebounds in output and private sector investment during periods of relative calm. While the

external trade balance during the period showed large deficits, the overall balance of payments was almost always in surplus and the fiscal and monetary imbalances were kept at tolerable levels.

In the last two years, however, the economy has experienced a dramatic deterioration which is still unfolding. The devastating effects of the Israeli invasion in mid-1982 marked a turning point for the economy not only because of the high level of destruction wreaked on the southern half of the country including the capital, but also because of the ensuing developments which led to a much sharper fragmentation of the economy, a more widespread breakdown of security, a large displacement of population, and a growing feeling of pessimism on the part of the private sector. Domestic output in the last two years is estimated to have declined by about one third, the public sector deficit climbed to an unprecedented level, the overall balance of payments registered substantial deficits, and the Lebanese pound depreciated dramatically. At the same time, strains began to emerge in the banking sector which prior to 1982 had been able to function relatively smoothly.

It should be clear that fundamental solutions to the economic problems facing the country require, first and foremost, an improvement in the security situation and the restoration of government control over all of the Lebanese territory. In the absence of such an environment, policymaking has had to be geared chiefly to limiting, within the obvious constraints, the general economic deterioration and the growing financial imbalances.

While the state of public sector accounts may not permit an accurate assessment of the sector's financial balance in recent years, the monetary data indicate strongly that the public sector deficit has been rising rapidly, reaching perhaps a level equivalent to three quarters of expenditures in 1984. A major factor behind the rise in the deficit has been the increased difficulty of collecting taxes and customs duties due to the worsening security situation and the widespread use of illegal ports. Another factor has been the sharp increase in public sector expenditure brought about by the higher transfers to the autonomous public authorities which were unable to collect fees and charges, the surge in domestic debt service requirements, and the need to alleviate the exacerbation of the social and economic conditions caused by the large-scale economic dislocation, the continued Israeli occupation of the south, and the general decline in economic activity.

In the face of the rising fiscal imbalance and its implications for the economy as a whole, a number of measures have been taken to boost revenues and contain expenditures. These include on the revenue side a government decision in November 1984 to close illegal ports, as well as measures to improve tax collection procedures such as the opening up of new branches of the Ministry of Finance in various regions in the country and providing additional incentives for tax collectors to perform their duties. While the new budget is still in the process of being finalized, the Government is determined to maintain expenditures in 1985 at about the same level as in 1984. Toward that objective, the Government has already trimmed about 15 percent from the proposed budget. Furthermore, the recruitment of additional public sector personnel has been stopped and prices of petroleum products have been raised to completely eliminate the government subsidy, which in 1984 amounted to about 6 percent of total expenditure. The expenditure program for 1985 of the Council of Development and Reconstruction (CDR) is targeted at LL 4.3 billioin, most of which will be directed toward rehabilitation in the areas of housing, health care, education, as well as basic infrastructure. The authorities, however, are keeping the expenditure target of the CDR under review in light of the security situation and the availability of external financial support.

Monetary developments in recent years have reflected to a large extent the growth in the public sector deficit and its financing through the domestic banking system. While the inflationary impact of the increased liquidity injection has been relatively moderate, owing partly to the openness of the economy, the balance of payments registered substantial deficits in 1983 and 1984 and the exchange rate of the Lebanese pound depreciated substantially. Monetary policy in the recent period has focused on four main objectives: absorbing the excess liquidity generated by the bank financing of the budget deficit; relying less on the central bank and more on commercial banks and the nonbank public to finance the deficit; containing the shift into foreign currency deposits; and protecting the solvency and financial position of commercial banks. Toward these objectives a number of measures have been taken including raising the reserve requirements of commercial banks, increasing the effective yield on treasury bills which raised the whole interest rate structure, lowering the minimum denomination of treasury securities to make them more attractive to the public, and expanding the role of the Société Financière du Liban (SFL) in absorbing excess bank liquidity into government securities. Moreover, in order to help ensure the smooth functioning of the banking sector during this exceptionally difficult period, the central bank introduced measures which required banks to maintain a minimum liquidity ratio of 25 percent and a minimum capital to asset ratio of 3 percent. At the same time, the banks themselves have been following a cautious policy by refraining from distributing profits and adding to their reserves and provisions against loan losses.

External sector developments in the last two years have reflected the general downturn in the economy, the growing fiscal deficit, as well as the reduced inflows of remittances and external aid. Substantial deficits have been recorded in the overall balance of payments which resulted in a marked decline in foreign exchange reserves and a substantial depreciation in the exchange rate. In the last few months, however, speculative pressures on the exchange rate intensified sharply, thus prompting the authorities to adopt a number of measures designed to reduce speculation against the Lebanese pound. These included a reduction and daily monitoring of the net foreign currency position which banks were permitted to maintain relative to their capital, the introduction of a 100 percent reserve requirement on Lebanese pound holdings of nonresident banks, and requiring commercial banks to provide daily information on overdrafts and on international trade credit. The authorities hope that these measures along with the policy of monetary restraint will help stabilize the exchange rate which will nevertheless continue to be determined by market forces and thus carry the brunt of balance of payments adjustment. The authorities are in agreement with the staff that no further use of foreign exchange reserves should be made to influence exchange rate movements. Moreover, it is now the policy of the central bank not to use those reserves, which have been depleting rapidly in the last two years, to finance public sector imports. Lebanon's exchange and trade system remains virtually free of restrictions and its external debt policy continues to be a cautious one with a debt service ratio which is low and declining.

In conclusion, the Lebanese economy has faced an increasingly difficult situation in recent years. Without the restoration of security and government control to all parts of the country, the scope for economic policy and its effectiveness would clearly remain limited. Until that is achieved, however, there is no alternative to using all the policy instruments which are available to the authorities in order to contain the general economic deterioration. Looking into the future, the authorities remain confident in the ability of the private sector, once the security situation is settled, to bring about a rapid economic recovery and to play a major part in the massive reconstruction effort which will be required.

Mr. de Maulde remarked that the Lebanese economy had continued to operate under extremely difficult conditions, including lack of security as well as social and political instability. Essential data were lacking; the Government had been prevented from exercising its authority, particularly regarding taxes, over more than one tenth of the nation's territory; and a consistent reconstruction plan had been impossible to implement despite the courageous efforts made since 1977 by the Council for Development and Reconstruction. Under such conditions, it seemed inappropriate to give the authorities the Fund's usual policy advice. International financial assistance was certainly needed, but peace and freedom to reconstruct, invest, produce, and trade was most essential.

The fiscal situation remained serious despite the courageous measures taken by the authorities, Mr. de Maulde noted. Government expenditures had risen in relation to revenue from 117 percent in 1979 to some 333 percent in 1984. The increase in the prices of petroleum products was a welcome step toward the elimination of subsidies, which accounted for 80 percent of the Government's foreign exchange expenditure. Other subsidies should also be eliminated as soon as politically and socially feasible to reduce the burden both on the balance of payments and on the budget deficit. The steps taken toward restoring the Government's authority over customs duties were courageous and commendable. Urgent consideration should be given to tax reform, enlarging the tax base, and improving tax collection, areas in which Lebanon would benefit from the Fund's technical assistance.

The sharp rise in general budget expenditures from LL 8.6 billion in 1983 to LL 10.9 billion in 1984 was cause for concern, Mr. de Maulde stated. The authorities should exercise greater control over current expenditures and greater selectivity with respect to reconstruction expenditures, which should be determined by the availability of foreign financing. The authorities' emphasis on meeting the population's basic needs and on providing incentives to revitalize private sector activity was appropriate.

A sound monetary policy should accompany the move toward greater fiscal restraint, Mr. de Maulde stated. In particular, the authorities should no longer treat the central bank's exchange profits as a way to finance the budget deficit and should strengthen supervision over commercial banks.

In the circumstances, there was no alternative but to let the exchange rate carry the burden of adjustment, Mr. de Maulde commented. The best way to alleviate the pressure on the Lebanese pound would be to improve the fiscal situation. In conclusion, the only actions that the authorities could take at present were those that would help to prevent the economic situation from deteriorating any further. He hoped that the political situation would improve such that the authorities could formulate appropriate policies for recovery.

Mr. Suraisry endorsed the thrust of the staff appraisal and indicated his support for the proposed decision. In the 1960s and early 1970s the Lebanese economy had been characterized by sustained growth and strong private sector activity. Unfortunately, the situation had deteriorated under the impact of growing political and security problems. In particular, the Israeli invasion in 1982 and Israel's subsequent occupation of southern Lebanon, an agriculturally rich area, had disrupted both the infrastructure and the productive base and had dislocated human resources. Could Mr. Finaish or the staff indicate how the economy had been affected by the occupation of the south? It would be useful if the staff could include an analysis of the impact of that occupation in its next Article IV report on Lebanon.

The Lebanese economy suffered from considerable economic problems, Mr. Suraisry noted. Growth had stagnated, the public sector deficit was too high, foreign exchange reserves were low, and the balance of payments position was weak. It was even more worrying that the situation might be even more serious than indicated in the staff paper, owing to the lack of sufficient data, a by-product of the security problem. The economic problems were, unfortunately, due to external exogenous factors which would have to be resolved before the economy could improve.

To their credit, however, the authorities had taken commendable measures to try to rectify the problems facing the economy, Mr. Suraisry remarked. The Council for Development and Reconstruction (CDR) had been reorganized in 1983 to strengthen its capabilities to formulate and implement development and reconstruction projects and to promote the role of the private sector. The CDR could play an important role in rebuilding the productive base of the economy and could benefit greatly from World Bank technical assistance. He would be interested in hearing the staff's comments on the relations between the CDR and the World Bank. While it was true that the openness of the economy and the extensive idle capacity might prevent pressure on domestic prices from developing, caution was required regarding the Council's spending program. Developments in domestic prices should be monitored closely and corrective measures taken if pressures emerged. He joined the staff in urging the authorities to consolidate the expenditure program of the CDR with the government accounts. Such action was particularly important given Lebanon's difficult fiscal position.

The fiscal deficit should clearly be reduced, Mr. Suraisry stated. He was concerned that while public expenditures had increased, owing to reconstruction efforts and the security problems, the authorities had lost control over important revenue sources. It was also worrying to note that domestic public debt service currently absorbed 50 percent of total budget receipts. The authorities had increased domestic revenues, but it was essential that they gain control over all revenue sources and that they terminate the practice of treating bookkeeping profits resulting from the depreciation of the pound as ordinary budget receipts. It was unwise to raise the interest rates on treasury bills to finance the deficit. The domestic public debt service was already too high, and the authorities might find it difficult to service their debt in the future. He welcomed the authorities' intention to maintain overall spending in 1985 at the same level as in 1984.

A reduction in the fiscal deficit would facilitate the management of monetary policy and would help the authorities to contain the expansion of domestic liquidity in 1984, Mr. Suraisry noted. Commendable efforts had been made to improve the banking sector, but it should be strengthened further given the important role traditionally played by that sector in the Lebanese economy. The increase in nonperforming loans and the fact that most of the new credit extended by banks had been to finance private borrowers' interest payments on existing debt were not healthy signs. A further strengthening and close monitoring of the financial system was called for.

The Lebanese pound had been under mounting pressure owing to the weakening balance of payments position and drawdown on reserves, Mr. Suraisry noted. He welcomed the steps taken by the authorities to alleviate such pressure, including the decision to cease providing the Government with foreign exchange to finance its operations. The pound had, however, recently depreciated to an unprecedented level and the authorities had been actively trying to correct the underlying economic and financial imbalances associated with that depreciation. Did the staff have any information on the current exchange rate and the response of market participants to the authorities' efforts? On a related matter, the authorities should be commended for pursuing a free exchange rate policy and maintaining a liberal trade system.

In sum, the authorities faced enormous economic problems caused by factors largely beyond their control, Mr. Suraisry remarked. They had taken some measures to deal with those problems, but there was still room for further action. He agreed with Mr. Finaish and the staff, however, that in the absence of a fundamental improvement both in security and in the authorities' control over the entire country, any adjustment measures could be only partially successful.

Ms. Bush noted that owing to the difficult security situation in Lebanon the 1984 Article IV consultation had been somewhat less detailed than was usually the case, although some useful policy discussions had taken place between the staff and the Lebanese authorities. The economy had been operating under adverse conditions, but the authorities had begun to take some steps to address the economic situation and she encouraged them to take further action to reconstruct and stabilize the economy.

Centralized control over revenues and expenditures was essential, Ms. Bush considered. In the recent past, the disturbances in the country had hindered implementation of a national fiscal policy. Consolidation of all budgets would provide a clearer picture of the fiscal situation and, in particular, would emphasize the need to restrain extrabudgetary expenditures. The priorities of the CDR, outlined by Mr. Finaish, seemed reasonable in view of the conditions in the country, and she encouraged the authorities to be selective in their expenditures and to prioritize projects, keeping in mind their ability to secure adequate external financing. She welcomed the authorities' commitment to revitalize the private sector. The practice of counting as fiscal revenues the profits resulting from the pound's depreciation should be discontinued, as those paper profits had been used to justify higher expenditures while access to real domestic resources had declined.

The elimination of petroleum subsidies, improvements in tax collection, and limitations on access to treasury advances were positive developments, Ms. Bush continued. The Government had agreed to cease using the central bank's official reserves for purchases of imports, a practice that had contributed to the sharp drop in official reserves in 1984, which Lebanon could ill afford given its long-term rehabilitation requirements.

While those improvements were welcome, they were insufficient to reverse the severe deterioration in the fiscal position, Ms. Bush went on. The public debt sector deficit had increased by 43 percent in nominal terms in 1984. Only 25 percent of expenditures had been covered by domestic receipts, the remainder being financed by the banking system. While the authorities' efforts to expand sales of treasury bills by offering high interest rates would reduce the Government's need for bank financing, it would also draw upon savings that the private sector could be using to stimulate growth. The authorities should monitor developments closely to ensure that the private sector would have adequate access to credit.

The rapid monetary expansion resulting from the wide budget deficit should be controlled so as to lessen demand for foreign currencies and increase willingness to hold the Lebanese pound, Ms. Bush stated. She commended the authorities for maintaining an open trade and exchange system, the consequence of which, however, was that any domestic imbalances had an immediate and strong effect on the external accounts and exchange rate. The Government's policy of nonintervention in the exchange market was appropriate, but the pound's depreciation could not be stopped until domestic imbalances were reduced. She welcomed the termination of two bilateral payments arrangements and supported the proposed decision.

Mr. Wijnholds noted that Mr. Finaish and Directors had referred to the difficult political situation and lack of security in Lebanon which had affected the country's economy. Mr. Finaish, however, had mentioned one neighboring country specifically. The situation in Lebanon was complicated, and more than one neighboring country or one party was involved.

The Director of the Middle Eastern Department stated that the World Bank had been involved in formulating a reconstruction and development plan in 1982/83 that had been composed of three one-year programs to be implemented in 1983-85. The officials of the CDR had, however, disagreed with the World Bank on both the size and the priorities of the three-year development program. The Lebanese authorities had wanted to direct outlays to basic needs, such as electricity, water supply, and education, rather than to reconstruction efforts. In any event, the foreign resources necessary to finance the program had not been forthcoming and the CDR had proceeded to implement some of the components of the amended program, largely with domestic resources. The World Bank had approved a $50 million emergency loan to Lebanon in 1977, a substantial portion of which had been disbursed.

The central bank had been supporting the Lebanese pound through intervention in the markets until about November 1984, the Director noted. The Lebanese pound had depreciated from LL 7.5 per U.S. dollar in November 1984 to LL 14 per U.S. dollar at present, as central bank intervention had slowed considerably. Central bank reserves, excluding gold, had declined from $715 million in November 1984 to $611 million at the end of January 1985.

Little information was available to assess the impact on the economy of the occupation in the south of Lebanon, the Director of the Middle Eastern Department commented. Productive activity had been affected during the occupation in mid-1982. Subsequently, transportation and the marketing of goods had been seriously affected. To the extent data were available, the staff would try to include more analysis of this problem in future papers on Lebanon.

Mr. Finaish remarked that as Directors had noted, the security problems in Lebanon had made it difficult for the authorities to formulate or implement effective economic policies. They had, however, made an effort, within the constraints, to limit the deterioration in the economic situation. During the past ten years, the Lebanese population had faced exceptional circumstances experienced by few other countries. Human suffering and physical destruction had been extensive. The authorities' ability to adapt to the changing environment and to avoid financial crisis until 1982 was remarkable.

In the aftermath of the Israeli invasion in mid-1982, however, economic conditions had changed dramatically, Mr. Finaish noted. The significant decline in real GDP and the deterioration in the country's financial position had been due, in part, to the increased fragmentation of the economy. Nowhere was that fragmentation so obvious as in the southern part of the country. The movement of goods and people between the south and the rest of Lebanon had been restricted by the Israeli occupation for a long time. Even when movement had not been completely restricted, it had been so costly that domestic trade with the rest of the country had declined sharply. The movement of goods by trucks from the regional capital in the south of Lebanon to Beirut--a mere 30 miles--had taken between three and four days owing to delays at checkpoints. Goods from the rest of Lebanon to the south had to be sent by boat. Not only were producers in the south finding it difficult to sell their agricultural products in the rest of the country, they were also facing severe competition from Israeli goods. Consequently, agricultural output in the south was estimated to have declined by about 40 percent in 1983.

The worsening security situation had negatively affected private sector activity and workers' remittances and had contributed to the fiscal and external imbalances, Mr. Finaish went on. Although the availability of information on the economic situation was limited, press reports gave a clear picture of the economic implications of the occupation in the south. He welcomed the staff's assurances that it would address that issue in future reports on Lebanon.

The Lebanese authorities broadly agreed with the views expressed in the staff report, Mr. Finaish indicated. They were committed to a market-determined exchange rate. Despite central bank intervention in the foreign exchange market aimed at smoothing sharp fluctuations in the value of the Lebanese pound, the pound had continued to depreciate. The central bank had decided to stop intervening and to let the exchange rate find its own value in the market. A number of steps taken by the authorities to stem the excessive speculation had, apparently, had an impact on the market. In an open economy such as Lebanon, a sharp depreciation in the exchange rate would inevitably translate into sharp price increases and would exert pressure on wages. Moreover, as a segment of the population received its income in foreign exchange in the form of remittances, a sharp deterioration of the currency would have implications for income distribution that could lead to serious social and economic problems. For those reasons, economic policy in Lebanon had focused recently on the exchange rate.

While public sector expenditure had increased in relation to GDP in recent years, real GDP had declined by more than one third in the past two years, Mr. Finaish remarked. The increase in the size of the public sector did not reflect a shift in economic policy away from the free enterprise system but was due to the security situation; the role of the public sector would have to increase in the future, particularly during a period of reconstruction, as the Government would have to direct spending to areas and sectors affected most by the hostilities.

The Chairman made the following summing up:

Executive Directors were in broad agreement with the thrust of the views in the appraisal of the staff report for the 1984 Article IV consultation with Lebanon. They expressed appreciation for the difficult conditions under which the authorities had had to conduct economic policy and commended the authorities on the measures taken to deal with the fiscal and monetary imbalances. Directors noted, however, the general deterioration of the economy, particularly over the last two years, coinciding with a worsening of the security situation. Directors noted the recent introduction of a more flexible and pragmatic approach to the Government's reconstruction and development program, but in view of the reduced availability of external assistance they emphasized the need for more vigorous domestic resource mobilization.

As regards financial developments, Directors focused their comments on the sizable fiscal deficit. They noted that the overall public sector deficit amounted to some 75 percent of total expenditure, which was clearly unsustainable. Noting recent fiscal measures, speakers underlined the need for further action to reduce the fiscal imbalance by adopting measures to reduce expenditures, especially extrabudgetary outlays, and by intensifying efforts to increase revenues. Directors commended the recent monetary measures to contain the fiscal deficit's impact on liquidity creation but noted that these could not be sufficient in the absence of stronger action in the fiscal area. Directors urged the authorities to terminate the practice of considering central bank exchange profits as government revenues.

Noting the rapid decline in official reserves, Directors strongly endorsed the policy of nonintervention in the exchange market. In the circumstances, there was no alternative to letting the exchange rate bear most of the burden of adjustment. They also concurred with the decision of the central bank to cease supplying the Government's foreign exchange requirements from its reserves. Directors commended the authorities' continued adherence to a free exchange and trade system.

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

4. AUSTRALIA - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with Australia (SM/85/30, 1/29/85; and Sup. 1, 2/15/85). They also had before them a report on recent economic developments in Australia (SM/85/35, 2/5/85).

Mr. Rye made the following statement:

The staff's 1984 Article IV report and its supplement provide an accurate and perceptive picture of recent and prospective developments in Australia. The focus of the report on the risks posed for the sustainability of the recovery by imbalances in the fiscal and external accounts and by the threat of a breakout in labor costs is, in my view, well placed.

While fully aware of the challenges posed by present circumstances, the Australian Government is not as pessimistic as the staff seems to be about the durability of its present blend of policies. The Government believes that any tightening of conventional policies beyond that already envisaged is unnecessary at present and could indeed be counterproductive.

The Australian economy is now well into a second year of recovery after the sharpest recession in postwar history. In 1984, the growth of real GDP was greater than in any of the major OECD industrial economies except the United States. Employment has increased strongly since the trough level in April 1983, and unemployment has declined.

Most significant of all, the moderation of inflationary pressures achieved during the recession has been maintained during recovery. The CPI increase for the December quarter provides the latest evidence of the significant progress made. Australia's inflation rate in 1984, the lowest in 12 years, was close to the OECD average--whereas, the year before, it was almost double that average.

While this strong improvement in the economy is partly attributable to some developments over which the present Government (elected in March 1983) had no control, staff are correct in acknowledging that "an expansionary fiscal policy underpinned by the Prices and Incomes Accord...clearly contributed to the recovery" (p. 15).

The fundamental feature of the present Government's economic policies is its commitment to the pursuit of economic growth. As the Treasurer has recently said, "Government economic policy is sharply focused on consolidating and sustaining a broadly based recovery in the economy." While the defeat of inflation is clearly vital to sustainable economic growth, the Government has sought ways to combat inflation which do not inhibit growth.

Since taking office, it has therefore pursued a fiscal policy which the Treasurer has described as "responsibly expansionary." At the same time, monetary policy has been guided by the objective of providing sufficient liquidity to accommodate prospective real growth with the minimum unavoidable rate of inflation. Meanwhile, since the Australian dollar was floated and exchange controls were abolished in December 1983, the value of the Australian dollar has been a matter for the judgment of the market.

These macroeconomic pursuits have been underpinned by the Accord between the Government and the trade union movement. The Accord has multiple objectives and social purposes, but so far as the economy is concerned it is a pact which binds the unions to a degree of wage and industrial restraint unprecedented in a time of economic recovery. This restraint was agreed in exchange for a commitment from the Government to pursue policies which would produce growth and jobs. Thus far at least, the Accord has allowed strong recovery without the destructive round of wage and price inflation which has chopped off every earlier recovery for a decade or so. In short, the Government has been able to achieve what it set out to achieve--the simultaneous reduction of unemployment and inflation.

That said, there can be no quarrel with the staff assessment that the major question now facing Australia's policymakers is whether an upward course can be sustained in the growth of employment and output through 1985/86 without a revival of inflationary pressures and strains on the external position. The Government believes that it can--while acknowledging that risks to the sustainability of the recovery could arise in several areas of policy.

Continuing progress in reducing inflation is seen as a precondition for a sustained expansion of the economy. It seems that there is still some way to go before consumers and financial markets are convinced about lower inflationary prospects in the long term. Certainly, unduly large wage settlements could quickly lead to a resurgence of inflation that would undermine the basis for sustained growth--hence the emphasis which the Government puts on its incomes policy.

That policy is not merely a short-term instrument. The successful establishment and maintenance of the consensus technique, involving very close consultation and coordination with the trade union movement and with the business community, has a major long-term role to play.

It is worth emphasizing the unique nature of these arrangements, which have no parallel in previous Australian history (contrary, perhaps, to the impression given here and there in the staff appraisal).

The Accord with the trade union movement continues to be the key to the Government's economic strategy. So far, it has been a notable success, particularly in facilitating the difficult transition from the wages pause. As a breakdown in the Accord would require tightening of both fiscal and monetary policy with detrimental effects upon output and employment, it is recognized by all parties as vital that the Accord be held in place.

The challenge for 1985 will be to restrict earnings to the awards given by the Arbitration Commission and to avoid a breakout in nonwage labor costs, which seem to have been growing considerably faster than wages. A major test will occur when the Arbitration Commission considers this year a productivity-based wage increase in addition to the regular indexation increase.

On page 16, staff have recommended a modification of indexation arrangements such that wages are not automatically adjusted for changes in the terms of trade or in indirect taxes. While there is much to be said for this recommendation, I should mention that the question of discounting raises sensitive industrial relations issues. The Government strongly believes that frequent and substantial discounting made a major contribution to the collapse of the 1975-81 wage indexation system--hence the stronger presumption of full indexation under the present system. That said, discounting is likely to be one of the issues to be discussed in the review of the current wage fixing principles to be held later this year.

The Government does not agree with the staff's assessment that the fiscal stimulus imparted by the 1984/85 budget is excessively expansionary. It has taken the view that an expansionary fiscal policy sufficient to "kick start" an economy that had stalled need not destabilize subsequent growth.

In that latter regard, now that the economy is moving again, the Government has committed itself to reducing the fiscal stimulus, so that the private sector can lead the way in the further growth of the economy. In 1984/85, the budget deficit is being reduced from 4.3 percent of GDP to 3.3 percent.

For the three years of the present parliamentary term, the Prime Minister has made three unequivocal commitments relating to fiscal policy. The deficit will be further reduced in 1985/86, not only as a share of GDP but also in money terms; and in the subsequent two years, the deficit will not be increased as a share of GDP. The taxation burden will not be increased as measured by the share of commonwealth government revenue in gross domestic product. And the growth in total federal outlays will be held within the rate of growth of the economy as a whole.

The staff expresses considerable concern about the course of monetary policy. They argue that the credibility of monetary policy should be strengthened by a gradual winding down of the pace of monetary expansion so as to accommodate a lower component for inflation in the growth of nominal GDP.

The Government does not see in monetary stringency a viable mechanism for "bearing down" on inflation. Inflation is directly addressed by the Accord. Instead, the Government has pursued a monetary policy which it describes as "firm" rather than "restrictive" or "accommodating"--one which aims at allowing the money supply to grow at a pace that would accommodate expected nominal growth in GDP.

The recent decision to suspend announcement of M-3 projections should not be interpreted as a relaxation in monetary policy. It is clear from interest rates and the general state of the financial markets over the last few months that, despite growth in M-3 and other measures of the money supply at a rate considerably faster than expected at budget time, monetary conditions have been quite firm. In that context, current forecasts for growth in real activity and inflation in 1984/85 are very much in line with the forecasts made at budget time.

One particular point is worth making here. While recovery in business capital investment is proceeding, this is from a very low base and, with real interest rates remaining high, it would be prudent to regard that recovery as fragile. Any tightening of monetary policy that had the effect of further raising interest rates would run the risk of choking off this engine of economic growth.

In its midyear review of M-3 growth in January, the Government came to the view that the budget-time projection in the 8-10 percent range could be achieved only by severely tightening monetary conditions. Against the background sketched above, such a tightening might well have disrupted the recovery without producing any further gains against inflation. Moreover, in a context of deregulation of the financial sector, interpretation of the monetary aggregates has become progressively more difficult--an experience with parallels in the United States and the United Kingdom during earlier periods of financial deregulation.

Accordingly, the setting of quantitative monetary targets has been suspended for the time being, with the matter to be reviewed later in 1985. The Government will in the meantime pursue monetary policy by reference to a range of aggregates and key indicators.

The staff expresses concern that the external current account deficit in the last year or two seems to have been on the high side, seeing this as reinforcing their view of the need for more cautious domestic macroeconomic policies.

It is true that Australia's current account deficit has widened. Over the last 20 years, the deficit as a percentage of GDP has averaged about 3 percent. In 1983/84, it was about 4 percent and it now appears that in 1984/85 it will be upward of 4.5 percent. This is unusually high for this stage of the economic cycle.

Some of the factors accounting for the recent increase in the current account deficit are beyond government control (e.g., world commodity prices). Some are the result of changes in the nature of private capital inflow (increasing emphasis on debt financing rather than equity financing). Some reflect developments which are themselves favorable (e.g., stronger economic growth raising imports and increasing the net invisibles deficit). Nevertheless it is apparent that import growth is running well ahead of economic activity, at least for the moment. In this context, I draw attention to the Government's determination to preserve and further enhance the significant gains it has made in moderating upward price and cost pressures thereby benefiting Australia's international competitiveness.

The staff also notes the increase in Australia's total external debt in the last two years. While this increase has heightened the economy's susceptibility to external shocks, it is not regarded as a cause of concern. The great bulk of Australia's debt has been incurred by the private sector where, at least in principle, market disciplines should ensure that it is put to productive use. The Government's own external debt obligations are very moderate, having declined from 4.7 percent of GDP in 1979/80 to 3.8 percent in 1983/84.

These comments have concentrated on the main elements of macroeconomic policy and incomes policy, which are rightly the focus of attention at present.

Such policies are always important. However, at the risk of some oversimplification, it can be said that, in the main, Australia's economic growth rates have lagged behind the OECD average for much of the postwar period more as a result of inappropriate microeconomic policies--excessive regulation (including in the financial sector) and protection in its many guises.

In the financial sector, there has been a veritable revolution of deregulation during the last two years; this will culminate in the entry of foreign banks, the details of which are expected to be announced in a few weeks.

More generally, the Government has moved to examine the whole range of public regulation of industry, with a view to removing those regulations which serve no clear and useful purpose.

Nevertheless, it is appropriate that the staff again point to the need for the Government to resist pressures for increased protection and to work toward market-oriented solutions by gradually relaxing artificial barriers to trade, internal and external.

To the extent that assistance to industry has become more widely disbursed in recent years, the distorting effects of protection have become more serious. But at least there is now a more vigorous discussion of industry policy at the political level--and this has fostered a greater community recognition of the costs of protection and of the need for structural adjustment.

A theme of government statements on industry policy has been the need to develop a more competitive industry structure in order to improve long-term growth, employment opportunities and living standards. The Government has acknowledged that its industry policy objectives imply greater exposure of domestic industries to international trading, and that the achievement of its objectives will require reductions in protection levels. For example, the Prime Minister has said:

> "...it is clear that Australia will have to move away from policies which have as their only focus, the restriction of imports and to introduce programs aimed to facilitate structural change and develop strong, efficient and competitive industries."

A more rational protection policy will probably be largely brought about by way of tailor-made packages--such as that recently concluded for the motor vehicle industry. Needless to say, progress in reducing protection will be the easier in a context of continued economic growth.

Extending his statement, Mr. Rye stated that the consensus approach adopted by the present Government was unique for Australia. At various times in the past decade, economic recovery had been choked off by a wage explosion that had depressed profits and investment and had caused unemployment to rise sharply. To break that spiral, the Government had secured the cooperation of the trade unions in its economic policy through the Prices and Incomes Accord. It had also taken the business community and other groups, including the social welfare bodies, as fully as possible into its confidence. The authorities hoped to create a different environment in which the legitimate aspirations of the trade union movements could be met. They hoped that public opinion generally and peer pressure, in particular, could be effectively brought to bear against those in the trade union movement who might pursue excessive gains in wages and other work conditions and against those businessmen who might try to buy industrial peace at an excessive price for the economy as a whole. Legitimate questions about the durability and advisability of that approach could be and, indeed, had been raised in Australia. It would be wrong, however, to assert that Australian experience demonstrated that such an approach was bound to fail. No previous government had used the consensus technique, which involved close consultation with and coordination between the trade union movement and the business community. The authorities should be given credit for trying a new approach to change the unsuccessful pattern of the past.

Firm restraint on expenditures would be necessary in 1985/86, given the expansionary policy in 1984/85, Mr. Rye commented. The new Minister for Finance had begun on the formidable task of reducing the budget deficit and had made clear that there would be no room for any new spending initiatives in the next budget.

In its midyear review of M-3 growth in January 1985, the authorities had observed that the quantitative monetary aggregates had been running ahead of expectations within the framework of a recently deregulated financing environment and, particularly, a freely floating exchange rate, Mr. Rye remarked. They had concluded that monetary growth had not been excessive given developments with respect to interest rates, demand, economic growth, and inflation. Furthermore, growth in M-3 could be brought back on target only by imposing a degree of stringency that would endanger the recovery. In other words, the Government had been faced with three options: to simply allow the target to be exceeded, to adjust the target upward as had been the practice in the previous year, or to admit that it had no intention of meeting the target and that the usefulness of the target was no longer clear given the changing environment. The

Government had chosen the third course of action. Only time would tell whether that choice would reflect more negatively on the authorities' credibility than the other courses of action.

It could be argued that the recent sharp depreciation of the Australian dollar reflected a loss of credibility in the authorities' monetary policy, Mr. Rye continued. It was generally believed, however, that the exchange rate movement was an overreaction in Australian markets to the strength of the U.S. dollar and the partial strike in the public sector, which had delayed substantially the collection of government revenues, thereby adding to liquidity and driving short-term interest rates down. Nevertheless, the recent movements in the Australian dollar were hard to explain and were perhaps a classic example of overshooting of the floating exchange rate.

Mr. Pérez congratulated the authorities for the remarkable progress achieved in the past year, following the deep recession of the previous two years. Australia was clearly among those countries that had begun to pursue an expansionary path, and it had done so firmly. Some major economic indicators were expected to be better than originally projected. The Government's policy package was consistent with its economic projections for the coming months.

More specifically, fiscal policy was a key element of the authorities' policy approach, Mr. Pérez considered. The fiscal deficit was expected to be reduced in 1984/85, both as a percent of GDP and in money terms, and he welcomed the authorities' intentions to continue reducing the deficit. Tax administration had been an important element of fiscal policy; the reduction of the fiscal deficit had been founded primarily on a revenue increase of 17.7 percent in nominal terms. Excessive public expenditure could jeopardize achievements with respect to inflation and employment. Furthermore, a loose expenditure policy would raise the public sector borrowing requirement (PSBR). The proportion of the PSBR absorbed by the state and local authorities gave cause for concern as the rate of increase in the financial resources required by those authorities could cause structural problems in the medium term. Private savings had begun to increase following two years of poor performance, and it would be dangerous to crowd out the private sector as a result of an excessive increase in the financing need of the public sector.

He welcomed the authorities' initiative and the principles motivating the tax reform, another important aspect of fiscal policy, Mr. Pérez remarked. The aims of avoiding an increase in the overall tax burden and of making the system progressive and more compatible with an improved climate for investment, growth, and employment, were encouraging.

He fully agreed with the authorities' assessment of the Prices and Incomes Accord as a cornerstone of their macroeconomic policy, Mr. Pérez commented. The Accord would facilitate the pursuit of consistent policies, thereby clarifying the economic horizon and improving expectations. It represented an appropriate trade-off between inflation and employment, and could, if commitments were fulfilled, render a great deal of stability. Only one element of the Accord might threaten the strength of the agreement--the nonwage claims. The nonwage costs were increasing in proportion to total labor costs, and if not clearly regulated, they could become a major obstacle to the achievement of lower costs, increased competitiveness, and the creation of new jobs. On a related point, the recent increase in employment had been fueled mainly by the strong fiscal impulse which had triggered job creation in the service sector. That upsurge in employment should be shifted to other sectors.

The main structural problem of the balance of payments seemed to be the rapidly increasing net invisibles deficit, Mr. Pérez considered. The trade imbalance of 1982 had been corrected as a result of the economic recovery of Australia's trading partners. The small surplus on the trade balance contrasted strongly with the current account deficit of $A 6.7 billion. The best efforts of the authorities should be devoted to achieving a sufficient trade surplus, while implementing a domestic policy mix that would improve the structure of the balance of payments. The increase in the debt service as a percentage of exports of goods and services from 17.7 percent to 41.7 percent in the past two years was worrying. He welcomed the Prime Minister's indication of Australia's intention to move away from protectionist policies. He would expect that the structural change planned in the industrial sector would not imply the imposition of permanent protectionist measures and that current quotas would be temporary in nature, in force only during the period of adjustment.

Mr. Jaafar observed that the authorities and the staff held almost opposite views about the conduct of policy in Australia. Mr. Rye's opening statement, which had clearly presented his authorities' views on the major issues, called for a response from the staff on many of those issues, some of which went to the very heart of the authorities' approach in addressing the problems of economic stagnation, a high rate of inflation, and rising unemployment.

The Government's policy of fiscal stimulus, initiated in 1982 and underpinned by an incomes policy in the form of wage restraint, had clearly been successful despite the Executive Board's misgivings about that policy at its discussion of the 1983 Article IV consultation with Australia (EBM/83/161, 11/23/83), Mr. Jaafar observed. GDP growth had been restored, and the economy had been enjoying a strong recovery in the past two years, with a large improvement in employment and inflation. The key to that outturn lay largely with the success of the Accord, which had been unexpected given Australia's history of unsettled labor relations. The Accord had effectively contributed to restraining wage growth, improving business profitability, stimulating investment and economic growth, creating new jobs, and drastically reducing the rate of inflation from 11.5 percent in 1982/83 to 6.9 percent in 1983/84. Developments in the short term would depend greatly on the social partners' commitment to the Accord. If the recovery continued, concerns might be raised by the social partners about the adequacy of the Accord. As there was considerable slack in the economy, with unemployment at close to 10 percent at present, those concerns were, however, unlikely to be raised in 1985. While unemployment remained high, the possibility of a wage drift in excess of what had been agreed under the Accord was limited. The risks associated with the expansionary fiscal policy would have been considerably greater if unemployment had been in the range of 6.7 percent and if the Prices and Incomes Accord had not been in effect.

He agreed with Mr. Rye that there was no clear danger in the short term in the authorities' policy approach, but in the long term the staff's concern over the rising trend in public expenditure was not entirely misplaced, Mr. Jaafar remarked. The structural component of the budget was large, and any cut in expenditure would require a reduction in transfer payments that could prove painful and difficult to implement. Any efforts to contain the budget would require the introduction of revenue-raising measures, as the scope for cutting expenditure was limited. The authorities' commitment to containing the budget was evident from their efforts to reduce the deficit to 3.3 percent of GDP in 1984/85 and even further in 1985/86, but they should not rule out the possibility of increasing revenues if expenditure restraint proved difficult to implement. He welcomed the discussions underway on a substantive reform of the tax system, the urgency of which was underscored by, inter alia, the spreading incidence of high marginal tax rates on personal income.

The rapid rise in the PSBR did not augur well for private investment activities, although he reserved his comment on that point on account of the reported buoyancy of the private sector investment demand, Mr. Jaafar said. Nevertheless, the rise in the PSBR should be monitored as it could pose problems in the future if it pre-empted more of the needed private investment financing. The external debt profile did not look encouraging, although he noted Mr. Rye's assurance that most of Australia's debt had been incurred by the private sector and could be subject to market discipline. The authorities' policies regarding external debt seemed to run contrary to conventional wisdom--namely, to reduce debt-creating flows in favor of nondebt-creating flows, such as direct foreign investment or equity. Could the staff or Mr. Rye explain the reasons for the policy switch in favor of debt-creating flows to finance investment activities?

Australia provided a good example of how and why protectionism was counterproductive, Mr. Jaafar noted. The high degree of protection of Australian industries partly accounted for the lack of industrial efficiency. While it was regrettable that the authorities were increasingly supplementing tariff barriers with nontariff barriers such as quotas, his chair urged them to dismantle all such barriers to imports. Australia's exports to Japan, the United States, New Zealand, and the surrounding region, notably the ASEAN countries, had increased. He wondered why imports from ASEAN had fallen sharply by about 20 percent between 1982/83 and 1983/84, whereas imports from Australia's other major trading partners had increased significantly. Returning to the question of protectionism, the trade barriers in other countries to some of Australia's exports was a source of grievance for the authorities. He hoped that those trade issues could be settled by the parties involved or through the efforts of the GATT. He encouraged the Executive Board and the management and staff of the Fund to intensify their efforts against the spread of protectionism.

Mr. Leonard noted that in the past 18 months the Australian economy had made an impressive recovery from recession, as indicated by the solid economic growth, rising employment, and a moderation in inflation. The authorities had shown courage, individuality, and skill in their use of a stimulative fiscal policy combined with wage and price restraint and a neutral monetary policy to boost output while dampening inflationary expectations. They had also shown a readiness to tackle structural problems, as shown by the additional measures taken to deregulate the financial system. Given those achievements, no major change in the course of Australia's economic policy was required. Nevertheless, the present economic developments were not without risk and, in order to minimize the threats to their plans, the authorities should be prepared to address a number of areas of weakness in the economy noted by the staff.

Fiscal policy and, more specifically, the public sector borrowing requirement needed careful monitoring, Mr. Leonard considered. The fiscal stance of the past two years had been an important element in stimulating economic recovery, but as in a number of other industrial countries, it had contributed to a rapid increase in the cost to the budget of servicing government debt. Moreover, the deficits of the state and local sector had risen, so that the overall PSBR had reached 8 percent of GDP in 1983/84 and was expected to decline by only 1 percentage point in 1984/85. Borrowing of that order in Australia was probably close to the upper limits of what was tolerable; if it were not contained, inflationary pressures would reassert themselves and could disrupt the Government's economic strategy. He was therefore encouraged to learn that the authorities recognized the potential threat of a rising PSBR and were taking steps to reduce the Commonwealth deficit and to put a cap on public sector borrowing by the different levels of government within the Commonwealth.

There was some acceptance of the view that an incomes policy could be an effective instrument of demand management for short periods, but there were few supporters for the idea that an incomes policy combined with an expansionary fiscal stance provided a sure medium-term route to sustainable growth in employment, Mr. Leonard noted. Australia could prove to be an exception to that latter view. Certainly, the Australian system of industrial relations was special and had probably helped the Government and the unions to interact effectively in the past two years in the pursuit of pay moderation. During that period, the rate of inflation had been reduced considerably, while real wages had not been lowered significantly. Nevertheless, some problems with the Prices and Incomes Accord were beginning to appear. He wondered whether the current unrest in the public service would spread into other sectors, particularly given the degree of centralization in wage bargaining, and bring an end to the incomes policy. The incipient trend toward productivity adjustments as an element in pay settlements was worrying since such adjustments, combined with wage indexation based on prices, would inevitably force prices upward. Could the staff or Mr. Rye say a few words on those points? Across-the-board wage bargaining introduced rigidities in relative wages that were not easily removed through ordered systems of consultation, collective bargaining, and adjudication; recourse to market mechanisms would eventually be necessary.

The Accord was likely to lose its moderating influence on wages over time, Mr. Leonard considered. The essence of the Accord was pay moderation on the trade union side in return for the promotion of growth and higher employment through fiscal expansion on the government side. If, however, public expenditure were curbed and the fiscal deficit reduced in the next few years, as was the authorities' plan, the overall stance of fiscal policy would be contractionary rather than expansionary and there would be little inducement for the trade unions to maintain their side of the Accord. In such circumstances, pay moderation would have to come about by means other than the Accord. The present incomes policy was a temporary element in the management of the Australian economy rather than a long-term instrument as described by Mr. Rye.

By abandoning the use of M-3 as a monetary growth target, the authorities were joining a number of other countries in relating their monetary policy to a wider system of reference points, Mr. Leonard observed. Their decision to abandon monetary growth targets was realistic and pragmatic given the unstable behavior of M-3. Provided that the general stance of monetary policy continued to be neutral and did not accommodate wage or price pressures within the economy, there need be no undue concern about the change.

In sum, the independent-minded approach of the authorities to restoring growth at lower rates of price increases than in the past had achieved important successes, Mr. Leonard considered. Much of the success was attributable to special features of the institutional environment. It would be unwise, however, to suppose that the current arrangements were sturdy enough to be useful tools of economic management in the long term. The authorities were aware of the potential dangers of their strategy, and they would leave room for adjustment should dangers actually arise.

Mr. Wijnholds remarked that although every economy was unique, it was useful to compare the performance and policies of a particular economy with that of similar countries. Such a comparison was difficult in the case of Australia. While comparable in size to the economies of some smaller industrial European countries, the Australian economy differed greatly from the European economies; it was a more closed economy, with exports of goods and services accounting for only 15 percent of GDP, and it had outperformed the European economies in terms of growth and employment. The recent Australian economic performance was, however, similar to that of the United States. The economies of both countries had grown rapidly; real GDP was expected to increase by 4 percent in 1985; the rate of inflation was about 5 percent; and both countries had large budget deficits and current account deficits, which had been financed by large inflows of capital from abroad. The favorable economic performance of the two countries had not, however, been attained through the same policy mix.

Australia's favorable growth performance during the past two years could be attributed to the authorities' efforts and policies, Mr. Wijnholds remarked. As in the United States, the expansionary fiscal policy had provided stimulus to the economy from a demand side, and private investment had eventually picked up despite high interest rates. An important difference between the United States and Australia had been the emphasis of the Australian authorities on an incomes policy to contain wages and, thereby, inflationary pressures. In the United States the role of containing wages fell to monetary policy. The staff was clearly uneasy about Australia's reliance on an incomes policy and had noted that, without appropriate action on fiscal and monetary policy, incomes policy would probably be effective only in the short term. The authorities should heed the staff's warning, as it would be unfortunate if the favorable performance of the past two years were dissipated because of a demand policy that was too relaxed.

It was rare that a country relied heavily on an incomes policy in the management of its economy, Mr. Wijnholds noted. Indeed, the experience of various countries using that instrument had generally been favorable only in the short term. Nevertheless, it should be kept in mind that each country had different institutional characteristics, which made the use of some policies better suited for some countries than for others. The Fund should not, therefore, be dogmatic about the application of certain types of policies. If incomes policies were rigid and relied heavily on indexation schemes they would probably not be effective in the longer run. But they could play a useful role in some countries if applied in a more informal manner by underpinning fiscal and monetary policies. Such an approach had been successful in Austria and, at times, in his own country.

Wage indexation arrangements needed to be examined carefully, Mr. Wijnholds stated. The possibility that a productivity adjustment might be made, in addition to the indexed wage increases, was worrying. An increase in pension benefits, while having a smaller inflationary impact than a wage increase, would still increase the costs of the corporate sector. The staff was correct in stressing that economic growth would increase if the rise in real labor costs were held below that of productivity. There was a danger that the authorities might feel that any adverse effects on the competitive position of substantive increases in labor costs could be overcome by a downward adjustment of the exchange rate. Such action would remove a further constraint against inflationary pressures. The floating of the Australian dollar, which had helped to make monetary policy more effective, should not, however, be seen as a mechanism for automatically adjusting Australia's competitive position.

More effort could have been made to reduce the budget deficit, particularly given the unusual increase in revenues, Mr. Wijnholds remarked. Although the budget deficit for 1984/85 was about 1 percentage point of GDP lower than in the previous fiscal year, the structural deficit had apparently increased. The authorities had explained that expenditure restraint had been difficult because a large proportion of outlays had been fixed owing to formal indexation and cost-sharing arrangements. While those arrangements limited expenditure restraint in the short term, they could be changed, as was evident in other countries.

He shared the authorities' concern about the recent high rate of growth of the money supply, Mr. Wijnholds stated. While he recognized that financial deregulation could make the interpretation of monetary aggregates difficult, the authorities' decision to suspend announcement of M-3 projections could be interpreted as a sign that they were relaxing monetary policy, a stance that might lower the public's confidence in the Government's policy.

He welcomed the staff's analysis of trends and developments in the external debt situation of Australia, Mr. Wijnholds commented. The total debt service ratio, on a net basis, was about 24 percent of GDP, and was expected to rise in coming years. The increase in debt was partly due to the shift in the composition of foreign capital away from direct and equity investment toward debt. He wondered if the staff could provide an explanation for that development. Mr. Rye had pointed out that Australia was directing borrowed resources toward productive uses, such as the development of natural resources, and that the level of debt need not be a cause for concern given the ability of the country to manage its economy. Nevertheless, the authorities should monitor the growth of external debt closely and should not allow the present trends to continue in the years ahead. In conclusion, he commended the authorities for the favorable economic performance, increasing their development assistance, and opening up financial systems to foreign competition, but he also endorsed strongly the staff's warnings regarding the sustainability of the recovery.

Mr. Clark noted that the Australian economy had made an impressive recovery in the past two years: GDP had grown rapidly, the rate of inflation had fallen sharply, and export performance and private sector investment had been better than expected. Those favorable developments had been due in part to exogenous developments, but they also reflected the authorities' policy of fiscal stimulus combined with wage restraint. Like other Directors, he was concerned about the sustainability of the recovery. Tighter demand policies would be necessary to avoid risking a resurgence in inflation and to reduce the pressure on the current account. He therefore welcomed the authorities' commitment to reducing the Commonwealth budget further in 1985/86, although, depending on the size of that reduction and on developments in the rest of the public sector, further restraint in the following years would probably be necessary.

While much progress had been made in removing regulations, particularly in the financial sector, the economy remained overregulated in a number of areas, Mr. Clark considered. Further action was necessary to reduce protectionism and remove constraints on private direct investment. Greater flexibility on the supply side would also be necessary to ensure the sustainability of the recovery within the demand management framework he had suggested. In that respect, he was concerned that the authorities regarded incomes policy as having a major long-term role to play. The success of incomes policy in restraining wages and inflation in the short term had been at the cost of prolonging the already rigid wage relativities across different sectors. Damaging effects on growth and inflation were likely in the medium term if such rigidities persisted.

General government savings had fallen to an extremely low level in 1983/84, a development that underlined the need to restrain current expenditure, particularly budgetary transfers, Mr. Clark commented. Expenditure restraint in the government sector should be matched by restraint on the part of the state and local authorities whose combined deficit had increased sharply in recent years. He welcomed the introduction of a system of limits on global public sector borrowing as a first step toward controlling local government expenditure. Further progress could be made in that area during the forthcoming review of the level of assistance to be provided by the Central Government to the states.

He hoped that the authorities would resume the setting of M-3 projections in 1985/86, particularly to keep inflationary expectations in check, Mr. Clark stated. He wondered whether the effects of the structural changes in the economy referred to by Mr. Rye in his opening statement might be overcome by targeting a wider range of aggregates, as had been done in other countries. He agreed with the staff's suggestion that the authorities should review the wage indexation system so as to exclude the effects of changes in indirect taxes and terms of trade.

Although Australia had traditionally been a capital importer and had, hence, run a current account deficit, the deficit of 4.5 percent of GDP projected for 1984/85 was high, particularly when viewed in the context of the staff's medium-term projections, Mr. Clark remarked. The projected rise in the debt service ratio to 40 percent by the end of the decade was worrying and raised questions about the prospects for the following decade. Although the majority of that increase in debt reflected borrowing by the private sector, presumably to finance profitable investments, some liquidity problems could arise in future years. Another contributing factor to the increase in foreign indebtedness had been the shift from equity financing toward debt financing, a development that reinforced the need to reduce barriers to direct inward investment.

Mr. Suraisry indicated his broad agreement with the staff appraisal. During the past two years, Australia had enjoyed improved economic activity, reduced inflationary pressures, and increased employment, owing largely to an expansionary fiscal policy and a successful incomes policy. Other contributing factors included improved weather conditions and the economic recovery in the OECD countries. The sustainability of the growth in output and employment, the main challenge facing Australia, would depend greatly on the Government's success in containing inflation. He welcomed Mr. Rye's assurances that the authorities would be able to achieve those objectives, but continued reliance on an expansionary fiscal policy could undermine the fight against inflation and weaken the Accord with the labor unions.

Although expansionary fiscal policy had helped to pull the economy out of a deep recession, the continuation of such a policy could undermine the authorities' efforts to sustain the recovery, Mr. Suraisry considered. The present fiscal stance should be moderated by slowing the rate of expenditure growth. He welcomed the authorities' commitment to reduce the budget deficit further in 1985/86 and their introduction of global limits on public sector borrowing.

Any strains on the current incomes policy should be avoided through strict adherence to anti-inflationary policies, Mr. Suraisry remarked. The authorities should continue linking wage increases to productivity gains. He agreed with Mr. Wijnholds that an incomes policy could play an important role in some countries if it were implemented flexibly.

Monetary policy should be consistent with the anti-inflationary fiscal stance, while ensuring adequate credit to the private sector so as to stimulate continued growth in output and employment, Mr. Suraisry commented. The staff correctly argued that a reduction in the public sector deficit would allow for an expansion in private investment. He supported the authorities' move to deregulate the financial system, which should improve competition among financial institutions, thereby encouraging an increase in savings and investment.

The pursuit of a flexible exchange rate policy had helped to maintain Australia's export competitiveness, Mr. Suraisry noted. A moderation in domestic demand would improve the country's balance of payments position, particularly the current account, which had been under strain in recent years. He encouraged the authorities to reduce protectionism by abolishing trade barriers. The increase in the debt service payments in the past few years was cause for concern, and he urged the authorities to monitor developments in that area closely. Finally, he commended the authorities for their recent economic successes and hoped that they would implement appropriate policies to avoid overheating the economy and to ensure sustained noninflationary growth.

Mr. Fujino observed that the Australian economy had recovered since mid-1983 from the short-lived, but deep postwar recession of 1982/83. Real GDP growth had reached 5.7 percent in 1983/84, and although economic activity appeared to have slowed in the first half of 1984/85, it remained broadly in line with the authorities' projection of real GDP growth of about 4 percent. The underlying rate of consumer price inflation had improved and the rate of inflation was currently about one half of its 1982/83 level. While Australia's economic recovery had been keeping pace with the strong recovery in some industrial economies, the domestic policy mix, structured on a delicate balance between the successfully enforced incomes policy and the expansionary fiscal policy supported by the less accommodating monetary policy, had made an important contribution to the improvement in growth. The authorities should be commended for attaining that successful result. The recovery had not, however, been broadly based; private consumption had grown only slowly and business-fixed investment had declined. The economic recovery in the current fiscal year seemed to be more balanced. Could Mr. Rye or the staff elaborate on Australia's economic performance, particularly on the impact of the fiscal stimulus.

The containment of labor costs had been the major factor behind the slowing of inflation and had contributed to the recent recovery in corporate profits, which promised an increase in private business investment, Mr. Fujino commented. He agreed with the staff that there were certain risks associated with the present policies, particularly with the threat of a breakdown in the Accord and escalating labor costs and with the imbalances in the fiscal and external accounts.

The Government recognized that continuing large fiscal deficits could have adverse effects on the economy, although it could be argued that a larger than planned reduction in the deficit would be desirable, Mr. Fujino noted. The large budget deficit in 1983/84 had been financed relatively smoothly from domestic sources, although the sharp increase in borrowing by the nonbank private sector might have strained the financial markets. He would appreciate some comments from Mr. Rye or the staff on that point. As domestic demand increased, the budget deficit should be reduced. Current spending was particularly hard to control, and in addition to the large social security payments, the interest costs of previous budget deficits represented a significant proportion--about 8.5 percent--of expenditure in the 1984/85 budget. The authorities' commitment to reducing the budget deficit further in 1985/86, not only as a share of GDP, but also in money terms, was particularly welcome.

The staff described the authorities' monetary policy as playing a supporting role in the achievement of noninflationary growth, Mr. Fujino noted. He interpreted Mr. Rye's statement describing the monetary policy stance as firm as meaning that the authorities were aiming at a more moderate rate of monetary growth. After the growth of M-3 fell within the projected range in 1983/84, the rate of growth of M-3 in 1984/85 had been at higher levels through December 1984. Although deregulation in the financial sector, which itself was a welcome development, made the interpretation of monetary aggregates more difficult, it was encouraging that the authorities agreed that inflationary expectations were still relatively strong and that the credibility of monetary policy should be strengthened further. The authorities' decision to suspend announcement of M-3 projections would make it all the more important to monitor other indicators of financial conditions more carefully, particularly if their decision was not to be interpreted as a relaxation of monetary policy. He welcomed the notable developments in the deregulation of the financial sector. The opening of the market to foreign banks, the details of which were expected to be announced in a few weeks, would make the market viable and internationally competitive, so that it could serve as an effective intermediary for the funds to the industries.

The decision to float the Australian dollar in December 1983 would increase the effectiveness of monetary policy, Mr. Fujino remarked. The successful operation of the floating exchange rate, however, called for sound domestic financial policies, because the exchange rate movements would reflect developments in the economy. The fact that Australia's debt service burden was projected to rise significantly over the next few years reinforced the need for more cautious domestic financial policies. Finally, he could support the conclusion of the staff appraisal.

Mr. Templeman remarked that the staff report presented a favorable picture of recent economic developments in Australia. Economic growth, private investment, and employment had recovered owing largely to a significant moderation in labor costs and an improvement of business profitability. The expansionary fiscal policy had also been an important source of economic growth. Continued fiscal expansion, however, was a source of risk for the sustainability of the economic recovery, as were the dangers of wage pressures and the large external deficits. It was particularly heartening to see that employment growth was accompanying the growth of GDP, and that unemployment had begun to decline from its mid-1983 peak. Employment in 1984/85 was expected to grow further, although not by as much as the 3.25 percent originally forecast. He wondered to what extent the rising employment in the public administration accounted for the overall employment growth.

Clearly, the favorable effects of wage restraint were a major factor behind the progress made in reducing the rate of inflation, Mr. Templeman observed. The initial wage freeze, followed by the current wage indexation system, might have interrupted the previous wage pattern and helped to reduce inflationary expectations. The risk of wage resurgence was serious, however, and the formal and across-the-board wage indexation made him uncomfortable, notwithstanding the evident determination of the authorities to make the current incomes policy work. He would welcome further assessment by the staff or Mr. Rye of the extent to which contractual wage increases could be avoided, the possible adverse effects on labor mobility of reduced wage differentiation, and the current thinking of the Government about wage policy following the expiration of the present two-year indexation arrangement. Could the staff also comment on the rise in nonwage labor costs which had the effect of increasing costs without raising take-home pay and which might negatively affect the willingness of unions to exercise wage restraint? He hoped that the authorities would give serious consideration to excluding changes in the terms of trade and in indirect taxes from the indexation system, although he recognized the sensitivity of that issue. Nevertheless, eliminating the effects of worsened terms of trade from the index could help to avoid potential conflict over income distribution following any sudden changes in the terms of trade. Furthermore, excluding indirect tax changes from the index might help to make tax policy more effective, particularly in influencing private consumption.

The staff correctly stressed the importance of a firm fiscal policy, Mr. Templeman considered. Aside from the recent deliberate expansionary shift in the fiscal stance, there had been a longer-term rise in the ratios of spending to GDP for both the Commonwealth budget and the public sector as a whole. The annual rate of increase in expenditures in the Commonwealth budget had been large both in nominal and real terms. Deficits in that budget of 3-4 percent of GDP and deficits at the state and local levels of government of nearly that size had led to a PSBR ratio equivalent to 7.8 percent of GDP in each of the past two fiscal years. He welcomed the authorities' intention to avoid any increase in the tax burden and to prevent the budget deficit from widening further. They should therefore focus their efforts on expenditure restraint. The share of spending accounted for by transfer payments for personal benefits had risen substantially, a common phenomenon in the industrial countries. Could the staff indicate whether Australia was experiencing an aging of the population, or other demographic trends, that might be aggravating the problem? The debate in Australia on tax reforms seemed familiar, touching on such matters as reduced tax rates on personal income, a broader personal income tax base, possible changes in treatment of fringe benefits and capital gains, and the role of taxation on consumption. He would be interested in any update on the status of that debate.

He was more concerned than the staff about the large external current account deficit and poor foreign debt outlook, Mr. Templeman indicated. There had been a real effective appreciation of the exchange rate from the fiscal year 1979/80 base level shown on page 76 of the report on recent economic developments in the range of 5-20 percent. The appreciation was particularly marked when using unit labor costs for the calculation. The sharp drop in the rate in February might have corrected any overvaluation and the recent growth of nonrural exports seemed quite favorable. Efforts to maintain competitiveness should be directed toward containing the growth of domestic costs. He was concerned about the nature and cause of the large portfolio investment inflows, particularly the portion not accounted for by borrowing by public enterprises. Despite the relatively low ratios of net debt to GDP, the medium-term scenario prepared by the staff indicated that the debt service ratio could be in the range of 37-42 percent, depending on the assumptions, by 1989/90. Given those high projections, close monitoring of foreign debt was called for.

The decision to float the Australian dollar had been helpful in insulating domestic monetary policy from possible volatile capital movements, Mr. Templeman remarked. He supported the deregulation and modernization of the financial system and could understand the authorities' wish to suspend the announcement of M-3 projections given the transitional problems associated with assessing the significance of changes in the monetary aggregates during a period of financial deregulation. The authorities' actions should not be misinterpreted as a relaxation in monetary policy. Finally, he welcomed the decision to allow foreign banks to operate in Australia as one means of expanding and modernizing the financial markets.

He hoped that in implementing that policy the authorities would be liberal in terms of the number of banks that could enter the market and in the conditions of their entry.

Mr. Salehkhou remarked that the Australian economy had shown resilience and flexibility during the past 18 months, enabling the authorities to pursue measures aimed at stimulating growth, and reducing unemployment and inflation, while avoiding the usual problems associated with such policies. Following two years of economic decline, real GDP had risen by 8.25 percent in 1983/84, with both private fixed investment and public sector expenditure contributing to the acceleration of production. At the same time, employment and the rate of inflation had decreased.

The driving force behind the economic expansion had been the fiscal stimulus arising from the budget deficit and relatively high PSBR, Mr. Salehkhou noted. The increase in the Commonwealth budget deficit in 1982/83 had partly reflected the cyclical downturn. But the continued increase in that deficit in 1983/84 had resulted from a decline in revenues as a ratio to GDP, reflecting a cut in personal income tax. The Commonwealth budget deficit was projected to decrease by 1 percentage point of GDP in 1984/85 owing to higher revenues. The authorities had been successful in striking a delicate balance between the need to maintain growth momentum, while avoiding an escalation of the budget deficit. They were aware of the need to keep fiscal developments under constant control. He would appreciate further comment by the staff on the estimated size of the structural budget deficit and the likelihood of its reduction or elimination in the near future. The overall aim of fiscal policy had been to generate sustainable economic growth, while containing inflation and isolating any undesirable effects on interest rates and, hence, on the buoyant private sector activities. To ensure the achievement of such goals, the authorities had pursued a vigorous incomes policy. Their efforts had already led to a sizable increase in private sector profitability and investment, which had added to the momentum initially generated by the rise in public sector investment.

The authorities had made effective use of projections of the rate of growth of broad money in an effort to achieve their objective of reducing inflation, Mr. Salehkhou noted. M-3 growth targets in the range of 8-10 percent have been established for 1984/85 based on an estimated moderate rate of GDP growth, an implicit price deflator, and a small increase in the income velocity of M-3. So far in 1984/85, the rates of growth of most monetary aggregates had been higher than the target range, but the authorities were not unduly concerned owing to the seasonality of fluctuations in monetary aggregates. They were, however, fully aware of the inflationary effects of continued overshooting of the monetary targets and would be reviewing the monetary projections in January 1985. A welcome aspect of financial and monetary policy had been the continuing deregulation of the financial system, including measures to eliminate lending guidelines for commercial banks, relaxation of control over savings banks, and the recent decision to permit foreign bank participation. He agreed with the staff's suggestion that indicators of financial conditions other than M-3 should be monitored given the increasingly diverse nature of the financial market as a result of deregulation.

Weak commodity prices and buoyant domestic activity had weakened the external current account position, Mr. Salehkhou noted. The balance of payments position was influenced by large capital inflows. The real effective exchange rate of the Australian dollar had pursued a generally downward trend since the decision to float the currency in December 1983, despite a lagged response. There were close links between the postfloat movements of the currency, the fluctuations in the U.S. dollar, and interest rate and inflation differentials, as could be observed by exchange rate developments since December 1983. Based on historical relationships, the Australian dollar was likely to depreciate in the next year if present domestic policies remained unchanged, assuming the continued strength of the U.S. dollar, larger external current account and budget deficits, and the current interest rate structure. With domestic inflation and interest rates roughly in line with those in other financial centers, the exchange rate of the Australian dollar might be a determining factor in the volume and direction of private capital flows. Private capital inflows had fallen from A$ 6 billion to A$ 2.3 billion in the course of 1983/84 owing to the floating of the Australian dollar. Could the staff indicate the likely trend of the exchange rate and capital movements?

He welcomed Australia's contribution to official development assistance, although it remained substantially short of the UN target of 0.7 percent of GDP, Mr. Salehkhou noted. Australia's ODA had risen by 17 percent in 1983/84 compared with a year previously, but was expected to remain constant in 1984/85 despite the economic improvement. Could the staff explain how the educational costs of students from developing countries studying in Australia were accounted for in ODA. Finally, he broadly agreed with the staff appraisal.

Mr. Grosche observed that the authorities had embarked on a macroeconomic program that combined an expansionary fiscal policy with an incomes policy aimed at containing inflationary pressures. The financial markets had been deregulated and the Australian dollar had been floated. The authorities' policy approach had met with considerable success, at least in the short term; private investment had picked up; employment, especially in the services sector, had increased until mid-1984; and the rate of inflation had decreased sharply. The authorities should be commended for those favorable developments. He was concerned, however, about the long-term sustainability of the improved economic performance, the large imbalances in the fiscal and external accounts, and the unduly large wage settlements that could lead to a resurgence of inflation.

In the past, each upswing in economic activity had eventually been followed by a sharp rise in labor costs, which had adversely affected economic performance, Mr. Grosche recalled. The current Prices and Incomes Accord had thus far been successful in containing wage demands, but he agreed with other Directors that incomes policy was a temporary device rather than a long-term instrument. He therefore encouraged the authorities to supplement their incomes policy with a more prudent financial policy stance, which should underpin the anti-inflationary orientation of their economic strategy and thus broaden the base for sustained growth in the future. Another problem related to the current wage policy was the high degree of rigidity in determining relative wages. Centralized wage negotiations left little room for wage differentiation, and different developments in productivity, supply, and demand were not reflected in relative wages. He recognized that the authorities did not want to endanger the overall policy of wage moderation by emphasizing wage differentiation, but more flexibility in determining relative wages would be desirable and would enhance the overall efficiency of the Australian economy.

He urged the authorities to pursue a more restrictive fiscal policy, Mr. Grosche stated. The PSBR of 8 percent of GDP in 1983/84 was incompatible with domestic and external objectives. The budget deficit should be reduced both for domestic reasons, to reduce the burden of interest payments and to ease the pressure on the capital markets, and for external reasons, to improve the balance of payments position. He therefore welcomed the authorities' intention to cut the deficit in 1984/85 by 1 percentage point of GDP, an objective that was judged to be attainable on the basis of relatively optimistic assumptions regarding economic growth. The staff estimated economic growth to be about 4 percent in 1985, whereas the OECD projected a rate of growth for Australia of only 2.25 percent. He would welcome additional comments from Mr. Rye or the staff on the attainability of the deficit objective should economic growth be more in line with the OECD projection.

The emphasis of fiscal policy on expenditure restraint was appropriate, Mr. Grosche considered. Particular efforts should be made to reduce transfer payments, whose recent disproportionate growth should be examined closely. He would appreciate further comment from Mr. Rye or the staff on the current status of the debate on tax reform. The possible introduction of a broad-based consumption tax represented an innovative step and would draw the attention of tax policymakers in many other countries.

The authorities had suspended the setting of quantitative monetary targets, Mr. Grosche observed. The effect of financial deregulation and innovations in the financial markets on the definition and significance of monetary aggregates required careful review. The authorities had decided to suspend announcement of M-3 projections at a time when the rates of growth of M-3 and most monetary aggregates had been running at high levels. He encouraged the authorities to reintroduce monetary projections at a later stage. Other countries had continued to set monetary targets in times of financial innovation, in order to give credibility to their stance of monetary policy. Monetary expansion should clearly be controlled if wage and price pressures were to be contained. Although the staff presented some evidence that the authorities' monetary stance had been expansionary, the fact that interest rates were strongly positive in real terms because of the lower rates of inflation supported the authorities' view that monetary policy was firm.

Despite the generally favorable economic performance, the current account deficit had widened substantially, Mr. Grosche observed. The high degree of protection in Australia had significantly diminished the flexibility of the manufacturing sector, which had not offered additional employment opportunities. Could the staff or Mr. Rye comment further on how the competitiveness of the manufacturing sector might be increased and how its exposure to the international markets could be widened? In conclusion, he could support the staff appraisal.

Mr. Zhang commended the Australian authorities for their recent approach to policy making, which conveyed a lesson to many other industrial countries. The Australian authorities, unlike many others, had made a conscious effort to reach a consensus with the market participants. They had not relied solely on confrontation and the harsh, often ineffective, discipline of market forces to bring about an ideal working of the labor market. The authorities had taken advantage of a favorable combination of economic developments--strong foreign demand, unusually favorable climatic conditions, moderate wage bargaining owing to high unemployment, and reduced private medical costs resulting from the introduction of Medicare. The authorities had used the special institutional characteristics of wage bargaining in Australia to secure a moderation in nominal wage increases and the indexation provision of the Prices and Incomes Accord with the trade unions. At the same time, they had pursued a flexible approach toward opening up the economy further to the working of market forces by freeing the exchange rate and deregulating the financial system. The tax base had also been broadened to overcome the distortions and inequities of a system involving high taxes on wages and salaries, while taxes remained low or nonexistent on many other forms of income, most notably, capital gains.

The major concern at present was whether the growth of employment and output could be sustained through 1985 and 1986 without reviving inflationary pressures and straining the external position, Mr. Zhang noted. The welcome increase in corporate profits, marking a reversal of the trend of declining profitability, itself posed a risk of more militant wage bargaining. The staff rightly urged the authorities to avoid pursuing a strong expansionary fiscal policy in 1985/86, in the context of continuing rapid expansion in the private sector, so that incomes policy would not be exposed to unsustainable stress. Domestic development would depend also on the external environment, particularly the rate of expansion and the financial conditions in Australia's principal trading partners, notably the United States and Japan.

The authorities would have to tread a careful but determined path if expenditure on social security benefits was to be restrained without initiating labor unrest, Mr. Zhang remarked. Similarly, through careful and deliberate explanation of the issues involved and the need to avoid setting off an inflationary spiral, the authorities might be able to persuade the union to modify the indexation arrangements so as to exclude the effects of price increases resulting from exchange rate depreciation or from an increase in taxes on consumption. Clearly, a cut in personal income taxes would provide a favorable climate in which to negotiate with the unions. The Australian authorities were well aware of such issues and were adept at handling them. No incomes policy had a chance of succeeding for more than a short period without appropriate fiscal and monetary policies. But measures aimed at influencing wage and price behavior could greatly improve the outcome of fiscal and monetary restraint.

Mr. Mtei commended the Australian authorities for the continued progress made during 1984. They had pursued an appropriate policy mix including an expansionary fiscal policy aimed at stimulating growth and increasing employment, a Prices and Incomes Accord, and a cautious monetary policy that had helped to pull the economy out of recession and reduce the rate of inflation. Real GDP had increased, unemployment, although still high, had fallen by more than 1 percentage point, and the consumer price index had been the lowest in 12 years in 1984/85. The broadening of the recovery base was even more encouraging. Business investment was expected to grow by more than 5 percent in 1984/85, indicating that the recovery would be supported by fixed capital spending, which could provide sustainable stimulus to the economy. The progress was not without weaknesses, however. Growth in output had not been matched by similar improvements in employment. Unemployment, which still exceeded 8.5 percent, deserved the authorities' prompt attention. He wondered how long the Government's strategy could be pursued given the unfolding labor unrest.

The budget deficit had increased from 0.5 percent of GDP in 1981/82 to 4.5 percent of GDP in 1983/84 owing to the cuts in personal income tax within the framework of the Prices and Incomes Accord and the increased welfare expenditure, reflecting the authorities' expansionary stance of fiscal policy, Mr. Mtei observed. The potential inflationary impact of that policy had been mitigated by financing the deficit from nonbank domestic sources, primarily treasury and Australian savings bonds. The expansionary fiscal policy should be pursued with caution to avoid marring the achievements thus far. While the authorities had intended to reduce the budget deficit to 3.3 percent of GDP in 1985/86, the staff indicated that the budget deficit had been higher than expected in 1984/85 and was likely to remain high in the near future. That development was even more worrying given the downward rigidity of expenditures and the large proportion of welfare outlays, together with the policy of holding down the tax burden. He hoped that the authorities would use the occasion of the national tax summit in July 1985 to focus attention on the crucial question of the long-term buoyancy of Australian taxes. The public sector borrowing requirement had risen to 8 percent of GDP in 1983/84. The Government's decision to set voluntary global limits for all public sector borrowing was welcome, although they should perhaps be made mandatory limits.

The rapid financial innovation and deregulation measures taken by the authorities were commendable and should increase competition and efficiency in the economy, Mr. Mtei commented. He recognized that those reforms called for more sophisticated supervision and an adaptation of monetary policy. The authorities had decided to define the monetary projection range in terms of M-3. Their monetary policy had been designed to deal with cost-push inflation, while being expansionary only to the extent of accommodating mild cost and price increases in the framework of the Accord. Experience thus far demonstrated, however, that M-3 was an inappropriate indicator of money supply and was leading to a monetary policy that was too restrictive. The authorities had therefore decided to monitor a range of monetary aggregates and other key indicators of monetary conditions. He hoped that a suitable indicator of money supply would be found soon. Frequent speculative private capital inflows had made it more difficult for the authorities to control monetary aggregates. Credit expansion had thus far been well controlled; expansion in public sector credit had been modest, but indications were that public sector borrowing to finance the high budget deficits might accelerate.

Although a narrowing of the current account deficit had been expected because of improvements in the external market, better terms of trade, and improved domestic productivity and competitiveness, the deficit would be larger than expected in 1984/85 because of a rapid expansion in imports, Mr. Mtei noted. Could the staff or Mr. Rye indicate whether the increase in imports was made up of consumer goods or capital goods, reflecting rising capital investment by Australian industries? The productivity and competitiveness of Australian industries could be improved by reducing the substantial protection to a number of manufactured goods, such as textiles, footwear, automobiles, and transport equipment. Australia was concerned about the barriers facing its agricultural exports and should take action to dismantle its own trade barriers, particularly quotas. Furthermore, the shift away from foreign equity investment toward private sector external debt deserved close attention by the authorities in order to avoid the emergence of serious external debt problems in the future. Finally, he urged the authorities to increase ODA from 0.51 percent of GDP in 1983/84 to the UN target of 0.7 percent of GDP. He was also concerned about the high regional concentration of ODA and looked forward to greater diversity in the future.

Mr. Zecchini commented that it was interesting that at a time when economic policy in many countries seemed to be based on monetarism and rational expectations, Australia had successfully implemented a stabilization program based on a set of standard Keynesian policies. In the past two years, economic activity had recovered, stimulated by an expansionary fiscal policy and an effective control over the growth of incomes. Inflation had fallen dramatically as a result of that policy mix and cautious monetary management. Exchange rate flexibility had helped to maintain foreign competitiveness at a level that the staff defined as "broadly adequate."

Australian economic developments were interesting not only because they indicated how Keynesian economic management could be applied in the 1980s but also because they provided a number of points for reflection by both policymakers and the Fund, Mr. Zecchini considered. The first interesting point was that the business cycle and price stabilization were compatible with a system of 100 percent wage indexation, provided that there were enough unutilized resources in the economy and that the indexation mechanism was neutral in relation to wage structure. While that notion had been recognized by economists for many years, policymakers had tended to look at it with some suspicion, as if the adoption of an indexation system was always equivalent to a softening in any anti-inflationary efforts. In Australia, wage indexation had helped to reduce the uncertainty implicit in wage negotiations and, thus, had facilitated the implementation of the stabilization package. Two important conditions necessary for the success of that approach had been present in Australia; the initial level of the real wage rate had been determined in such a way as to be consistent with the need to achieve a higher level of employment, and the indexation mechanism had been sufficiently neutral to avoid distortions in the structure of relative wages.

A second interesting point for reflection was suggested by the latest development in economic activity, Mr. Zecchini stated. Despite strong fiscal stimulus, a buoyant rate of domestic demand, and a broadly adequate level of competitiveness, the growth of output and employment had begun to slow, and unemployment was still much higher than it had been prior to 1982. The lull in output growth could not be explained on the basis of underutilization of capacity. To understand why the fiscal stimulus was not improving the employment situation, it was necessary to look closely at the behavior of an economy under full wage indexation.

The key point was that if wages were adjusted to prices with a time lag, full wage indexation might create a situation in which real wages were negatively related to the rate of inflation over time; the lower the inflation rate, the higher the time average of the real wage, Mr. Zecchini went on. Assuming a predictable response of production units to the level of the real wage rate, there would be an inverse relationship between employment and the rate of inflation--a Phillips curve--that depended entirely on the institutional features of the indexation system, namely the fixed intervals and the 100 percent indexation coverage. In such a situation, higher levels of output and employment beyond a certain point were possible only if a higher inflation rate was accepted. In particular, an expansionary fiscal policy, such as the one implemented by the Australian authorities in the past two years, could not effectively stimulate output beyond a certain point unless it induced a higher inflation rate.

If his description of the current status of the Australian economy were to any extent accurate, there were a few conclusions that could be drawn for the policymakers, Mr. Zecchini remarked. No macroeconomic or public financial policy could lower inflation while raising the level of employment without changing some institutional features of the labor market. Both goals, however, could be achieved even if full wage indexation was preserved; for example, by lengthening the lag if wages were adjusted for prices, say, to one year. That action would permit a lower average real wage rate, while stimulating output at the current inflation rate, or, conversely, reducing inflation further for the same level of output. To the extent that the second objective was achieved, workers would tend to be compensated at a later date for the initial real wage loss. On the contrary, if the present fiscal stimulus was continued and the mechanism for determining wages maintained, it would be difficult to avoid a resurgence of inflationary pressures.

The current mix of restrictive monetary and expansionary fiscal policies could prove difficult to sustain in the medium term, as it would lead to increases in real interest rates that would negatively affect private sector spending, particularly investment expenditure, Mr. Zecchini stated. Trade unions would probably demand an increase in real wages, as the public sector had already done. Even if they did not, excess demand for output would be reflected in higher imports, which would have a negative impact on the overall current account. Indeed, the current account deficit was already increasing despite the broadly adequate competitiveness of the economy. Domestic prices would also increase to accommodate a rise in employment.

The authorities' approach to economic stabilization, implemented since early 1983, had thus far been very successful, Mr. Zecchini commented. The policy approach, however, seemed to be losing most of its effectiveness and the gains achieved to date might soon start to be reversed. The same farsightedness that had helped the authorities to steer the economic course in the past two years could be used to identify policy areas that would need to be corrected in order to ensure further progress.

Mr. Sengupta observed that the Australian Government had embarked on a path that was unique. He commended the authorities for pursuing an appropriate mix of incomes, fiscal, and monetary policies that had enabled Australia to make a strong recovery from its deepest postwar recession. Activity and employment had undoubtedly been stimulated by an expansionary fiscal policy, underpinned by a Prices and Incomes Accord acting as a major anti-inflationary instrument, and by monetary policy, which had accommodated the cost and price increases resulting from the Accord. The authorities were faced with the question of how to sustain the growth in employment and output in 1985/86 without allowing a resurgence of inflationary pressures and straining on the external position.

The authorities planned to reduce the fiscal deficit in 1985/86, Mr. Sengupta noted. Their commitment to preventing a rise in the overall tax burden implied that the growth in federal outlays would have to be held within the limits set by the rate of growth of the economy as a whole. The authorities' announcement that a tax summit would be held to discuss tax reform, which would be decided upon through a consensus of the various sections of the community, and their imposition of global limits on public sector borrowing were appropriate ways of addressing the problem of fiscal deficit. While there was merit in the staff's argument that some restraint would have to be exercised on transfer payments, including the social security benefits that accounted for a large part of total outlays, he agreed with Mr. Rye that the objective of reducing the overall public sector deficit should not be pursued for its own sake. Rather, it was important to ensure that the main aims of the Accord were fulfilled by pursuing policies that would improve growth and employment. He was not convinced that a reduction in the public sector deficit would automatically create the needed room for a continuing increase in private investment, which would provide the basis for a durable increase in the growth of employment, one of the Government's fundamental objectives. The crowding out phenomenon that was implied by the staff would arise when private investors found it hard to mobilize funds without raising interest rates. Interest rates in Australia had, in fact, declined in nominal terms since June 1983.

He welcomed the deregulation of the financial sector, Mr. Sengupta stated. The staff had argued that the M-3 growth projections for 1984/85 of 8-10 percent were broadly in line with the authorities' aim of containing inflation. The authorities, however, had suspended announcement of M-3 projections because the growth in M-3 had been considerably faster than expected. They had, instead, decided to monitor a number of indicators of economic and financial conditions, such as other measures of the money supply, interest rates, and exchange rates. The staff hoped that the pace of monetary expansion would be kept within the 8-10 percent range in 1984/85 and below that range in 1985/86.

The staff's preoccupation with money supply targets overlooked the important fact that the major anti-inflationary instrument had been, at least thus far, the wage restraint encompassed in the Accord, Mr. Sengupta commented. While unbridled monetary expansion would make inflation difficult to control, monetary policy should not be restrictive either. The supplement to SM/85/30 indicated that financial markets were firm, judging from the fact that treasury bond sales had been high in the first half of 1984/85. A reduction in the rate of increase of M-3 to the initial target range could, in the circumstances, disrupt the recovery. He agreed with Mr. Rye that any further increase in real interest rates would run the risk of choking off the recent improvement in business capital investment.

He commended the authorities and the trade union movement for achieving a successful Accord, which had played a substantial role in the current recovery, Mr. Sengupta considered. The authorities should continue pursuing a policy of wage restraint through the Accord to ensure a more durable recovery. He was not implying that wages should be frozen or semifrozen, irrespective of increases in real living costs, but was encouraging the authorities to seek an acceptable indexation system, keeping in mind the need to promote growth and employment, which had slowed somewhat in December 1984. There was a somewhat irrational belief in the conventional literature that wage accords could not be sustained in the long term or even in the medium term, mainly because organized labor could not be trusted to be reasonable. The Australian case might demonstrate otherwise. The Government must fulfill its commitment to pursue policies that would lead to economic growth and higher employment levels. If growth could be sustained, productivity would continue to increase. An orderly rise in real wages need not lead to inflation or a reduction in the rate of investment. There was therefore no reason why the Accord could not be sustained.

The large external current account deficit of about 4.5 percent of GDP, had been more than matched by large capital inflows, Mr. Sengupta noted. External debt had increased in the past few years but had not yet become unmanageable. He was not sure how realistic the real GDP growth assumptions underlying the staff's medium-term debt scenario were. The scenario would also change quite markedly if the authorities introduced trade liberalization measures, about which Mr. Rye had raised favorable expectations. He would appreciate staff reaction to his view that if the exchange rate policy were pursued in a flexible manner and domestic costs were restrained, the competitiveness of Australian exports would improve and they would be less subject to unfavorable exogenous developments.

Mr. Lundstrom stated that he could understand the authorities' reasons for pursuing an expansionary stance of fiscal policy since early 1983, at which time Australia had faced double digit unemployment rates, poor growth prospects, and low growth of private business investment. The risk of increasing inflation expectations was limited given the policy of wage restraint. The authorities' strategy had helped to achieve remarkably high growth and had reduced unemployment substantially, while reducing the rate of inflation to the lowest level in 12 years. Moreover, private investment had risen considerably and as expected to be more buoyant than calculated earlier. Those developments were impressive. They had, however, been accompanied by the emergence of a sizable fiscal deficit, and he therefore welcomed the somewhat less expansionary fiscal stance in 1984/85.

The authorities' decision to pursue a neutral monetary policy was reasonable, although further developments should be monitored closely, Mr. Lundstrom considered. Whether the latest upward pressure on interest rates was related to a large public sector borrowing requirement or to a tighter monetary policy stance was uncertain. Monetary aggregates had become more difficult to interpret after the deregulation of the financial market and the recent financial innovations.

The incomes policy pursued by the authorities had been an important instrument in restraining wages and, thereby, fostering a sustainable growth in output and employment, Mr. Lundstrom noted. The Government had not yet made any specific proposal regarding the principles that would govern the determination of wages after October 1985, when the entire system would be reviewed. He was, however, pleased to learn from Mr. Rye that an Accord with the trade unions would continue to be the key element in the authorities' economic strategy. In any new Accord, he hoped that the present system of full indexation would be moderated so that the economy could respond quickly and flexibly to changes in the external and internal environments.

Could the staff elaborate on the reasons for substantially raising its estimate of the debt service ratio for the remainder of the decade, Mr. Lundstrom inquired. Finally, he broadly agreed with the general conclusions of the staff report, particularly the assessment of the detrimental effects of protectionism and other forms of governmental industrial assistance and the recommendation that the Government should resist pressures for increased protection and should gradually relax artificial barriers to trade.

Mr. de Maulde observed that, on pages 82 and 83 of SM/85/35, the staff had criticized the Common Agricultural Policy of the European Community. It was regrettable that the staff had not presented a more balanced view of those policies by asking the European Community for its views on the subject. He pointed out that the EC was not only an exporter of agricultural products, it was also an importer of agricultural goods. The trade deficit of the European Community had amounted to about $20 million a year since 1970.

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

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/85/24 (2/15/85) and EBM/85/25 (2/20/85).

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/85/41 (2/15/85) is approved.

APPROVED: November 21, 1985

LEO VAN HOUTVEN
Secretary