MASTER FILES

ROOM C-120 04

NOT FOR PUBLIC USE

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/43

10:00 a.m., March 18, 1985

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
A. Alfidja	N. Toé, Temporary
	M. K. Bush
	D. C. Templeman, Temporary
	H. G. Schneider
B. de Maulde	X. Blandin
	T. Alhaimus
H. Fujino	M. Sugita
	B. Goos
	D. Hammann, Temporary
	T. Sirivedhin, Temporary
R. K. Joyce	L. Leonard
	G. D. Hodgson, Temporary
A. Kafka	
H. Lundstrom	H. Fugmann
E. I. M. Mtei	
F. L. Nebbia	B. Jensen
	J. E. Suraisry
	E. M. Taha, Temporary
	E. M. Ainley, Temporary
P. Pérez	J. de la Herrán, Temporary
	J. de Beaufort Wijnholds
	A. V. Romuáldez
G. Salehkhou	O. Kabbaj
	A. S. Jayawardena
	T. A. Clark
	N. Coumbis
Zhang Z.	Wang E.

L. Van Houtven, Secretary
S. L. Yeager, Assistant

Also Present

F. Fischer, Executive Secretary, Development Committee; C. Michalopoulos, Director, Economic Policy Analysis and Coordination, Economic and Research Staff; P. Landell-Mills, Western Africa Regional Office, IBRD. African Department: A. D. Ouattara, Director; G. E. Gondwe, Deputy Director; E. A. Calamitsis, R. O. Carstens, S. M. Nsouli, P. C. Ugolini. European Department: B. Rose, Deputy Director; B. Christensen, O. J. Evans, L. Hansen, P. L. Hedfors, H.-J. Huss, M. Ishihara, A. Knöbl, S. Mitra. Exchange and Trade Relations Department: C. D. Finch, Director; M. Guitían, Deputy Director; S. J. Anjaria, G. Begashaw, J. Berengaut, C. F. J. Boonekamp, J. T. Boorman, E. H. Brau, M. R. Kelly, N. Kirmani, B. J. Nivollet, A. B. Petersen, P. J. Quirk, M. H. Rodlauer. External Relations Department: C. S. Gardner, Deputy Director. Fiscal Affairs Department: M. Z. Yucelik. Legal Department: G. P. Nicoletopoulos, Director; A. O. Liuksila, S. A. Silard. Middle Eastern Department: J. G. Borpujari. Research Department: A. D. Crockett, Deputy Director. Secretary's Department: J. W. Lang, Jr., Deputy Secretary. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: K. A. Hansen, G. E. L. Nguyen, P. Péterfalvy, M. A. Weitz. Assistants to Executive Directors: H. Alaoui-Abdallaoui, J. R. N. Almeida, W.-R. Bengs, J. Bulloch, Chen J., A. K. Diaby, G. Ercel, C. Flamant, R. Fox, V. Govindarajan, N. Haque, A. K. Juusela, H. Kobayashi, M. Lundsager, R. Msadek, J. A. K. Munthali, K. Murakami, A. Mustafa, J. K. Orleans-Lindsay, J. Reddy, D. J. Robinson, J. E. Rodríguez, C. A. Salinas, Shao Z., L. Tornetta, Wang C. Y.

1. SENEGAL - REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the first review under the stand-by arrangement for Senegal (EBS/85/45, 3/1/85; and Cor. 1, 3/14/85), which had been approved on January 16, 1985 (EBM/85/7, 1/16/85.

Mr. Alfidja made the following statement:

> This first review under the new stand-by arrangement for Senegal shows that the Senegalese authorities are firmly determined to implement successfully their adjustment program aimed at achieving further progress toward a satisfactory economic growth and a viable internal and external financial position over the medium term. All the quantitative performance criteria for end-December 1984 were met, and the program remains on track.
>
> Concerning the 1984/85 budget, developments during the first six months of the fiscal year turned out as envisaged under the program, and net government borrowing from the banking system remained below the ceiling. Largely owing to the revenue measures introduced in January 1985, total revenue for 1984/85 is now estimated to be about 12 percent greater than in 1983/84. In furtherance of the objective of reducing the overall fiscal deficit, the authorities will continue to pursue prudent and flexible policies, particularly by restraining the increase in the number of government workers, thereby limiting the total wage bill, and by economizing on nonwage outlays.
>
> Monetary developments during the first six months of the program resulted in a 5 percentage point reduction in total domestic credit expansion below the projected target of 7.5 percent. This was largely due to lower net government borrowing from the banking system resulting from the encouraging fiscal developments during the period, especially the favorable revenue performance. As a result of the drop in the marketed output of groundnuts, the level of crop credit was lower than projected. Credit to the private sector, other than crop credit, remained on target.
>
> Senegal's foreign creditors have shown an encouraging understanding of the country's present difficult external position in the light of the authorities' resolve to pursue strong adjustment measures to attain a viable balance of payments position over the medium term. As a demonstration of their willingness to assist Senegal to overcome existing pressures on the balance of payments, these creditors have agreed to reschedule or refinance external debt service obligations falling due over the two-year period ending June 1986. As a result, Senegal's external debt service payments will be reduced from an estimated 27 percent of export of goods and services--before debt relief--in each of the two years 1984/85 and 1985/86 to 17 percent and 19 percent, respectively.

The internal and external imbalances facing the Senegalese economy are of a structural nature. My authorities, therefore, will continue to consolidate the gains achieved under previous adjustment programs with the help of the international financial community and friendly countries.

Mr. Taha stated that Senegal, with the cooperation of the Fund and the World Bank, had made substantial and commendable progress in recent years toward restoring domestic and external financial balance. The overall fiscal deficit had been sharply reduced, domestic credit expansion had moderated, and steady progress had been made toward eliminating domestic arrears. At the same time, the external imbalance had narrowed, reflecting appropriate demand management and a recovery in exports. The

Senegalese authorities recognized the need for continued economic and financial reforms, Mr. Taha continued. Saudi Arabia had supported their efforts and their continuing focus on two areas of fundamental weakness--agriculture and public finances. The present program dealt adequately with those and other reform issues; the program was on track, and all performance criteria for end-December 1984 had been met. He encouraged the authorities to build on those achievements in order to make further progress toward sustainable real economic growth.

Completion of rescheduling arrangements with the Paris Club and other creditors had reduced pressure on the balance of payments and the budget, Mr. Taha noted, providing the authorities with the necessary room for maneuver and enabling them to press on with needed reforms. Over the medium term, the achievement of sustainable domestic and external balance would require further debt rescheduling. As such arrangements were usually secured in the context of determined adjustment, the continuation of Senegal's efforts was therefore needed, together with financial support from the Fund.

Mr. Mtei recalled that the main purpose of the present review was to assess the adequacy of the debt relief arrangements which the Senegalese authorities were seeking from their creditors, so that the program could be modified if the debt relief obtained varied significantly from that originally envisaged. During the Board's consideration of the stand-by arrangement for Senegal, he had agreed with the staff that approval of the arrangement could be given because the measures undertaken were strong and comprehensive and because Senegal's track record had been favorable; thus, modifications to the program could be made when actual rescheduling arrangements had been completed. He was therefore pleased that both the Paris Club members and the commercial banks had been able to support Senegal's adjustment effort by providing debt relief on terms similar to those envisaged in the program. He hoped that other creditors would be able to provide further debt relief on comparable terms.

The authorities' continued commitment to the adjustment process was also noteworthy, Mr. Mtei added. Despite the difficulties inherent in the implementation of certain policy measures--particularly the pricing of consumer goods--the authorities had acted rigorously. Indeed, Table 3 indicated that all the measures agreed upon were either already in place or being implemented. Consequently, the program remained on track, with all the quantitative performance criteria for end-December 1984 having been met despite a drop in the marketed output of groundnuts. Thanks to the increase in exports of phosphates, a lower than projected import bill, and lower interest payments--all of which had mitigated the shortfall in export receipts from groundnut products--the authorities were confident that basic program targets would be achieved.

The problems facing Senegal would persist for some time, Mr. Mtei concluded, and successful implementation of the current program would be important in laying a strong basis for future growth and a viable balance of payments position in the medium term. He therefore urged the authorities to persevere in their endeavors.

Mr. de Maulde remarked that Senegal's performance under the program had been satisfactory so far. On the fiscal side, total revenues for 1984/85 were estimated to be in line with the level envisaged in the program, and total expenditures were expected to be CFAF 3.7 billion below the programmed amount; consequently, the deficit on a commitment basis would be equivalent to 3 percent of GDP, or marginally lower than the initial program target of 3.3 percent. The good fiscal performance would contribute to the moderation in the growth of the money supply. Those results derived from the numerous measures that had been implemented by the authorities as contemplated in the letter of intent and listed in Table 3 of the staff report. Some of those actions, such as the liquidation of SONAR, a rural development agency involved in the distribution of groundnut seeds, had been difficult to take and testified to the authorities' commitment to the adjustment effort.

The unforeseen drop in the marketed output of groundnuts--which at present was estimated to have fallen from an expected 450,000 tons to 260,000 tons for the current season--had adversely affected the balance of payments, resulting in a $27 million shortfall in export receipts, which fortunately had been offset largely by higher export receipts from phosphates and lower imports, Mr. de Maulde observed. The staff's explanation for that steep drop--a lower than expected crop and greater artisanal processing in response to the increased retail price of groundnut oil--was, however, not entirely illuminating. He could not but correlate the shortfall in groundnut production with the real net producer price for groundnuts. According to his calculations, and taking 1979/80 as an index base year, net real producer prices had been 29 percent lower in 1983/84, and even after the retroactive increase that had taken place in mid-January 1985, prices were 23 percent lower in 1984/85 than five years earlier. On the other hand, the international price of groundnut oil at present was approximately $1,000 per ton, which corresponded roughly to a price of CFAF 150 per kilogram for groundnuts, of which only

CFAF 60 was remitted to farmers. Taking into account costs such as transportation and processing, the difference of CFAF 90 per kilogram appeared large and could be a disincentive to farmers or could induce them to export to unofficial markets. Since the World Bank was concerned about the groundnut marketing problem, he invited the staff representative from the Bank to comment on that subject. The letter of the Acting Minister of Economy and Finance appended to the staff paper also indicated the Government's concern with the problems and prospects of the groundnut sector and noted a series of studies that had been undertaken following an interministerial meeting; he would be interested to know what actions were contemplated.

In concluding, Mr. de Maulde commended the Senegalese authorities for their strict adherence to the adjustment program.

Mr. Hodgson noted with satisfaction that the Senegalese authorities had reached understandings with their Paris Club and commercial bank creditors on debt rescheduling and that the stand-by program was generally proceeding as envisaged. The unexpected drop in marketed output of groundnuts was cause for concern, but the authorities appeared to be fully aware of the situation and should presently take appropriate steps to deal with it. He therefore supported the proposed decision and offered his continuing support to the Senegalese authorities.

Mr. Clark welcomed the good start that had been made under the stand-by program and the successful negotiations with the Paris Club. Noting Mr. Alfidja's comments regarding other creditors, he invited Mr. Alfidja or the staff to provide more detail concerning the agreements with the commercial banks. The debt reschedulings with the Paris and London Clubs were clearly vital for the short-term stabilization of the external position.

The steps already taken to implement the policy elements of the program were noteworthy, Mr. Clark continued. The measures to strengthen the agricultural sector--considering its key role in the economy--were extremely important, and he urged the authorities to press ahead with their plans for distributing fertilizers and groundnut seed and with reforming the Price Equalization and Stabilization Fund. He expressed satisfaction that economies had already been achieved in the fiscal area and that more were expected. Moreover, the study of the parastatal sector was almost complete; he looked forward to speedy action to reduce that sector's drain on public expenditures.

Despite those encouraging signs, Mr. Clark observed, Senegal would continue to face major problems for the foreseeable future. It was therefore vital that the current momentum be maintained, not only to attain a sustainable external position by the end of the decade, but also to provide a basis for securing the additional debt relief that would be required in the medium term.

Mr. Hammann agreed with the staff appraisal and supported the proposed decision. He noted with satisfaction that the adjustment policies under the current program were being implemented, but expressed concern that Senegal continued to face major structural problems and that its balance of payments position remained fragile. More specifically, he shared Mr. de Maulde's concern regarding the marketed output of groundnuts. As groundnuts constituted a major part of Senegal's exports, he wondered what advice on remedial action was being given by either the Fund or the World Bank.

Ms. Bush was reassured to learn that the debt rescheduling exercise had been satisfactorily completed and requested verification that the debt relief expected from non-Paris Club bilateral creditors in 1984/85 was SDR 9 million--the amount derived by subtracting the debt relief of SDR 61 million from the Paris Club and commercial bank relief of SDR 14 million from the total of SDR 84 million. In addition, she would appreciate any information that the staff could provide regarding further arrangements. As the financing gap had been filled and all end-December 1984 performance criteria had been met, she supported the proposed decision.

Noting that plans for the reform of the rice and other commodity sectors regulated by the Price Equalization and Stabilization Fund were to be adopted by the end of March, Ms. Bush asked whether the staff had any details on the nature of the reforms, particularly for the rice sector. Moreover, did those plans include a fairly speedy movement toward free-market determination of producer and consumer prices? She would also be interested to hear the response to Mr. de Maulde's question regarding the groundnut sector. She welcomed the World Bank's involvement in the reform of the institutional arrangements governing Senegal's productive and distributive sectors, and noted that a structural adjustment program was under discussion. She urged the rapid conclusion of those discussions in order to maintain the pace of supply-side adjustment.

With regard to fiscal developments, Ms. Bush noted, progress for 1984/85 appeared to be better than expected, with the deficit on a commitment basis projected to be 3 percent of GDP rather than the 3.3 percent originally envisaged. She noted that following the present review, discussions would begin concerning the targets and performance criteria for the coming fiscal year; she hoped that with the improved outlook for 1984/85, the targeted deficit on a commitment basis for 1985/86 could be close to, or even below, 1.8 percent of GDP--the lower end of the target range presented in the original program. Considering the bleak medium-term balance of payments outlook, the need for a strong fiscal adjustment effort still remained. In concluding, she supported the continued emphasis on the reduction of domestic arrears.

The staff representative from the African Department, commenting on the external debt rescheduling or refinancing arrangements, noted that the Senegalese authorities had already taken steps to implement the agreement reached with the Paris Club on January 18, 1985. Discussions with one of the Paris Club creditors had been initiated, and those with others were expected to commence in the near future, with the most important scheduled to take place in May. According to the Agreed Minute of the January 18, 1985 meeting, the necessary bilateral agreements were to be concluded with the least delay and, in any event, before August 31, 1985. The authorities had also had further discussions with commercial bank creditors of the London Club to settle some minor remaining differences, and the rescheduling agreement was expected to be signed shortly.

The authorities had contacted the two principal official creditors outside the Paris Club, and they intended to initiate discussions with other creditors, with a view to securing rescheduling or refinancing arrangements on terms comparable to those of the Paris Club, the staff representative continued. Those latter arrangements were estimated to yield debt relief of SDR 9 million in 1984/85 and SDR 15 million in 1985/86. The total debt relief was therefore estimated at about SDR 84 million in 1984/85 and SDR 77 million in 1985/86. Barring unforeseen difficulties, the program's balance of payments targets could be achieved even if there were a small shortfall in debt relief.

Concerning developments in the groundnut sector, the staff representative remarked, the size of the 1984/85 crop had doubtless been initially overestimated by the authorities. According to most observers in Senegal, the crop had been smaller owing to a combination of factors, including low rainfall, delays in seed distribution, and insufficient production incentives. Although the producer price of groundnuts had been raised from CFAF 70 to CFAF 80 per kilogram on a gross basis, or from CFAF 50 to CFAF 60 on a net basis--excluding the retainer that was kept from producers--the increase had come too late in the season to have the desired effect. Moreover, there were indications of larger artisanal processing of groundnuts in response to the increase in the retail price of groundnut oil in August 1984.

Clearly, it was difficult, the staff representative added, to attribute specific weights to all those factors that ultimately led to a marked shortfall in marketed output of groundnuts. Notwithstanding the prevailing structure of prices, a record crop had been marketed in 1982/83, which suggested that other factors could play a role at different times. However, the recent shortfall, with its consequent adverse impact on the operations of the two oil-milling companies, had heightened the authorities' concerns with the problems and prospects of the entire groundnut sector. As the staff report indicated, since late January an intensive review of various aspects of the sector had been undertaken by the authorities, in consultation with the resident representatives in Dakar of the country's principal creditors. In the past week, an interministerial meeting, chaired by the President of the Republic, had been held to consider a number of proposals; appropriate actions were expected to be taken in the near future in three areas. First, incentives for groundnut production would be strengthened, without compromising the desired increase in cereal output--another aspect of the new agricultural policy. Second, responsibility for the reconstitution of the groundnut seed stock would be progressively turned over to the farmers themselves or their organizations; the current procedure was costly, and, to the extent that the responsibility was turned over to the farmers, costs could be reduced substantially. Third, the costs of the oil-milling companies currently being compensated by the Treasury would be substantially reduced, a step that would probably require the temporary or permanent closure of some of the mills, since total existing processing capacity exceeded Senegal's current needs.

The studies of the rice sector, conducted by an international accounting firm and U.S. university experts, had been completed, and the proposals made in the reports were being considered by the authorities, the staff representative from the African Department explained. The proposals were of two sorts. One involved purely technical and accounting improvements, which needed to be addressed immediately. The other proposals were more fundamental and put forth alternatives for reorganizing the rice operations that were being handled by the Price Equalization and Stabilization Fund (CPSP). Three options were under consideration, which would be the focus of the staff mission for the second review under the stand-by arrangement. The first was the creation of a public entity completely independent of the CPSP to take over rice operations. The second was the complete privatization of the rice sector. The third option fell somewhere between the first and second and involved "semi-privatization": the Government would continue to make arrangements for rice imports from other countries, but, thereafter, purchases and sales would be left to the private sector. The staff, in collaboration with the World Bank, would be considering which of those three alternatives seemed to be the most efficient, the least costly, and the most stable in Senegal's circumstances.

The staff representative from the World Bank, commenting on the shortfall in groundnut production, remarked that the official estimates had been too high, but at the same time there was evidence that farmers had been unwilling to sell some of their crop to the oil mills, largely because the increase in the domestic oil price had made artisanal conversion of groundnuts into oil a viable proposition. The most worrying aspect of the problem was that although nearly CFAF 40 billion had been invested in the groundnut sector by external agencies over the past three growing seasons, production had not visibly improved. The major contributors had been the French and U.S. Governments, and the World Bank was working closely with other aid agencies and with the Senegalese Government to find ways to enhance production.

One aspect that had been inadequately studied in the past and needed to be given more attention was the functioning of the oil mills, the staff representative continued. The mills were working at 30-40 percent of capacity, which represented a tremendous strain on the economy because their losses were absorbed by the Government. Not only the relationship between the oil mills and the Treasury through the CPSP, but also the kind of rationalization that needed to be introduced, had to be examined carefully. Seed distribution also remained a problem; the second tranche of a structural adjustment loan had been canceled in 1983 because the

World Bank had not succeeded in reaching an agreement with the Government on seed distribution reform. The World Bank considered that farmers should stock their own seed and that the authorities' current practice of buying seed, storing it, and then redistributing it to farmers was wasteful. That practice was however so deeply ingrained that the authorities were worried about the risks that would be incurred were they to introduce a rapid change in it. To help them to deal with that issue, the World Bank was examining the establishment of a reserve stock which the authorities could use if an emergency situation arose because farmers proved unwilling or unable to stock their own seeds.

He agreed with the Fund staff that action was needed on three fronts, the staff representative from the World Bank concluded. First, reforms were needed at the producer level to improve incentives and the distribution of fertilizers and seed; second, the oil-processing system needed to be reviewed; third, marketing arrangements required study. The CPSP was under scrutiny in a study being financed by the World Bank. While the World Bank considered that some radical changes were needed to improve the CPSP's operations, the authorities were prudent and would need to be convinced that whatever new system was introduced was in fact an improvement. Nevertheless, the World Bank staff believed that the private sector should play a greater role in marketing, and that the CPSP should act primarily as an agent for price stabilization.

Mr. de Maulde inquired whether the oil-processing mills were working at 30-40 percent of capacity because of the reduced groundnut crop or because of the existence of excess capacity.

The staff representative from the World Bank responded that the reduced groundnut production reflected in part overestimations of production; in future, it would be important to determine the size of a normal groundnut crop. At present, the World Bank staff felt that the primary problem was overcapacity, which could be resolved by rationalizing the oil-processing mills.

The Executive Board then took the following decision:

1. Senegal has consulted with the Fund in accordance with paragraph 4(b) of the stand-by arrangement for Senegal (EBS/84/267, Sup. 3, 1/18/85), and paragraph 21 of the letter from the Minister of Economy and Finance dated December 3, 1984 attached thereto, in order to reach understandings with the Fund on the adequacy of arrangements for rescheduling Senegal's external debt.

2. The letter from the Acting Minister of Economy and Finance dated February 28, 1985 shall be attached to the stand-by arrangement. The Fund finds that no further understandings are necessary, and that Senegal may proceed to make purchases under the stand-by arrangement.

3. In accordance with Executive Board Decision No. 7908-(85/26) of February 20, 1985 on overdue payments to the Fund, the stand-by arrangement for Senegal is amended to read as set out in the Attachment to EBS/85/45 (3/1/85).

Decision No. 7936-(85/43), adopted
March 18, 1985

2. DENMARK - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with Denmark (SM/85/51, 2/12/85). They also had before them a paper on recent economic developments in Denmark (SM/85/66, 2/28/85).

The staff representative from the European Department informed the Executive Board that the outcome of wage negotiations in Denmark remained unclear. The private sector unions had given notice of wide-ranging strikes, and the employers had responded with a lock-out warning. The strikes were to start on March 4, but had been postponed for two weeks by the official mediator, who had the authority to postpone strike for two two-week periods; he had already used that authority for the second time. A possible conflict would thus be delayed until early April. Obviously, the outcome of the wage negotiations was crucial for economic developments in 1985 and 1986.

Mr. Fugmann made the following statement:

> Although the Danish authorities do not agree with all the points made in the staff report, they feel that it will be an excellent basis for a discussion on the Danish economy.
>
> As pointed out by the staff, while many economic developments in Denmark in 1984 were encouraging, at the same time, developments in the balance of payments were evidently disappointing. Demand--both from abroad and from domestic sources--was lively, and production grew by 4.5 percent compared with 1983, placing Denmark among the European countries which had the highest growth in 1984. Although the labor force continued to increase fairly rapidly, a slight reduction in unemployment took place. In line with the Government's objectives, the increase in total employment was concentrated in the private sector, also reflecting the fact that public sector demand in volume terms--in line with the expenditure programs--was almost unchanged in 1984. Private demand generally grew quite fast, most conspicuously in business investment. An encouraging feature of developments in 1984 was the strong increase in industrial investment under the influence of a sharp improvement in the profit situation in 1983 and 1984. The upswing in investment seems to be broadly based, and a desirable increase in production capacity in many exporting industries is under way.

The rise in wages in 1984 was in line with, or slightly lower than, the substantial deceleration expected for the year as a whole. Because of the rise in the exchange rate for the dollar, inter alia, no further deceleration in the rise in consumer prices was achieved in 1984. For most wage and salary earners, there was a slight fall in real disposable income. Private consumption somewhat surprisingly proved to be quite buoyant throughout the year, partly because the growth in employment also exceeded expectations.

Although there were disappointments in the export picture, not least in relation to net freight earnings, Danish export industries were able to take advantage of the pickup in demand which was evident in many countries in 1984. Whereas the U.S. market historically has not been very important to Danish industry, Danish exports under the impact of the high exchange rate for the dollar have been able to increase their share in the U.S. market. The competitive position of Danish industry developed somewhat differently in individual foreign markets in 1984. However, Danish estimates based on weightings from national trade statistics indicate that, overall, there was a slight improvement in the competitive position of Danish industry in 1984.

The main explanation for the disappointing balance of payments development for the year evidently can be found on the import side, where the effects of the growth in investment and private consumption made themselves felt. Increased stocks of imported goods, and the effects of the high exchange rate for the dollar on the terms of trade and the amount of interest payments were important explanatory factors in the negative development.

In designing its economic policy, the Government has attached considerable importance to the value of avoiding abrupt and unexpected changes, particularly in fiscal policy. The favorable effects of this attitude on the climate for business investments and the desire to avoid complicating the 1985 negotiations on new wage and salary agreements through fiscal action has been the main reason for the firm adherence to the fiscal program for 1984. In line with this attitude, economic policy in 1984 emphasized measures aimed at influencing economic development in 1985.

With a view to the expiration in early 1985 of the two-year agreement period in the labor market, a law was adopted in the spring of 1984 at government request, under which the suspension of the automatic cost of living adjustment of wages and salaries, which has been in force since the spring of 1983, was extended for two more years. The suspension will thus be in force until spring 1987.

The Government has refrained from indicating an official guideline for the wage and salary agreements currently under negotiation, but has clearly underlined the desirability of reaching a settlement between employers and unions that would mean a significant further reduction in the rate of wage increases below the present annual rate of 4-5 percent. Wage bargaining has already been under way for several months, but although the present contracts in the private sector expired in early March, the outcome of the negotiations is still an open question. The negotiations are complicated by the fact that the union side has put forward demands for a reduction in the standard 40-hour work week.

As indicated in the staff report, budgetary developments have been better than indicated in earlier estimates. Despite a continued sharp increase in net interest payments, the public sector deficit--including net interest payments--is estimated to be reduced from 9 percent of GDP in 1982 to 3 percent in 1985. The rapid improvement in budgetary developments since 1983 can be explained both by the effects of the economic upswing and by the determined efforts to contain the increase in public expenditures. Salary increases in the public sector have been lower than wage inreases in the private sector, and benefits under the unemployment insurance scheme and various social welfare schemes have been either frozen or permitted to grow only slowly. Public purchases of goods and services in volume terms were almost unchanged from 1983 to 1984. In 1985 a very limited increase in public sector capital expenditure is projected, while consumption expenditures are expected to increase by 0.5 percent. An important part of the endeavors to contain public expenditures is the efforts to keep municipal expenditures under control. To limit the potential of local authorities for increasing their expenditures, the Government has taken a firm stand aiming at the so-called block grants paid by the state to local authorities. These grants were virtually constant in nominal terms from 1982 to 1983 and will be reduced in 1985.

The Government has just begun preparations for the 1986 budget, and the Minister of Finance has publicly announced that the Government will continue its restrictive policy of avoiding increases in expenditures in real terms. As before, the target is to eliminate the deficit in the central government accounts by the end of the decade.

While the Danish authorities see some reason for satisfaction in budgetary developments since 1982, it is likely to prove difficult to achieve an additional tightening of the 1985 budget by way of further expenditure cuts. In line with the views in the staff report, the Danish Government would prefer to adopt any needed budgetary tightening by way of further expenditure cuts. However, for a minority government, the adoption of further expenditure cuts would require support from one or more other political parties. The Government has so far succeeded in creating a majority for a restrictive budgetary line prior to the adoption of the annual finance bills. That was also the case for fiscal year 1985, and the Government hopes that political agreement on a continued restrictive stance on government expenditures can also be achieved with respect to the 1986 budget. However, it is considered unlikely that a majority in Parliament can agree on further expenditure cuts in 1985. Therefore, if the need should arise for budget tightening in the short run--a possibility that cannot be excluded--it would in all likelihood have to be achieved through increasing government revenue one way or another. However, a political decision on the need for a tightening of the 1985 budget will not be taken until agreements have been reached on wage and salary rates in the ongoing negotiations.

In their demand management policy, the Danish authorities put the main emphasis on fiscal and incomes policies, while they view the principal objectives of monetary policy as support of a firm exchange rate policy and a level of interest rates conducive to the restoration of external equilibrium in the medium term. On both these criteria, they deem the present stance of monetary policy appropriate.

In its assessment of monetary policy, the staff report puts great weight on the development of the money stock. It points out that the growth of M-2 has for the last couple of years been somehwat in excess of the growth of nominal GNP and considers that to be a clear indication that monetary policy has been too expansionary and partly responsible for the setback in the balance of payments in 1984.

As also pointed out in the report, the Danish authorities believe that focusing on this particular indicator gives--to say the least--an incomplete picture of the stance on monetary policy. First, as a general observation, the role played by monetary aggregates in a large, self-contained economy is essentially taken over by the exchange rate in a small, open economy. An important test of the sufficiency of monetary policy is therefore whether it has supported a stable exchange rate. In fact, the krone has for quite some time been in the upper range of the European Monetary System (EMS) and the central rates vis-à-vis the deutsche mark, for example, have remained unchanged for two years.

Second, as also pointed out in the staff report, there has been a significant turnaround in Danish economic trends since the fall of 1982. Wage and price increases have been halved, the trend of government deficits has been reversed, and a firm exchange rate policy has been adopted. In such a transitional period, financial variables must also be expected to adapt and monetary aggregates to become particularly unreliable as indicators of the stance of monetary policy. Instead, monetary policy must be judged on the basis of interest rates which--despite their decline since 1982--have remained high in both nominal and real terms, by international standards.

Third, the competition between financial assets--those that are included within the definition of money and those that are not--is particularly keen in Denmark given the complete absence of interest rate restrictions and the absence of "taxes" on intermediation through banks in the form of unremunerated reserve requirements. In such a financial system, the dividing line between monetary and nonmonetary assets becomes particularly blurred, and monetary assets will be held not only for transaction purposes, but also as a store of wealth, the growth of which is not necessarily related to the growth of nominal GNP.

Fourth, the objectives of a firm exchange rate policy and freedom of capital movements to which the Danish authorities are strongly committed necessarily limit the autonomy of domestic monetary policies. This has been clearly illustrated in recent months when the tightening of bank lending guidelines and the fairly high level of yields on krone bonds attracted sizable capital imports.

In sum, my authorities find that concentrating on the growth of a monetary aggregate--to the extent seen in the staff report--gives an unbalanced picture of monetary conditions, at least under present Danish conditions.

There have been no significant changes in the stance of monetary policy since the consultation discussions in December. In January, the bank lending guidelines were extended in agreement with the bank organizations, and the growth of lending has come down from a year-on-year increase of 18 percent last summer to 12.4 percent at end-January. Over the last six months, the annualized growth has been only 6.8 percent. Despite sizable corporate borrowing abroad, particularly in October and November, companies continued to borrow also from domestic banks. Accordingly, the slowdown in domestic bank lending mainly reflects lower credit demand from the household sector. In fact, nonbusiness lending rose by only 1 percent in the fourth quarter of 1984 compared with an average of 5 percent in the first three quarters of the year.

In late 1984, banks had been buying sizable amounts of bonds, but these purchases were more than offset by large net sales in January. Given that bank lending and bond purchases are the principal counterparts of broad money, M-2, this aggregate fell considerably in January, reducing year-on-year growth to 15.6 percent and the growth over three months to less than 10 percent (seasonally adjusted and annualized).

With respect to exchange rate policy, no change in the views presented in the staff report has taken place. The Danish authorities consider it very satisfactory that no adjustment of rates had to be undertaken within the EMS in 1984. In view of the improved convergence in the economic development among the active participants in the exchange rate mechanism of the EMS, the Danish authorities hope and expect that there will be no need for an adjustment of the exchange rate grid presently applied by the participants in the exchange rate mechanism of the EMS in 1985.

A revision of the official macroeconomic estimates has not been made at this time. However, the Danish authorities are in broad agreement with the projections presented in Table 5 of the staff report. The Danish authorities agree that the increase in production in 1985 with unchanged economic policy is more likely to be above 3 percent than below. Industrial investment in the broad sense of the term, including investment in energy production and distribution and investment in ships and civilian aircraft, is expected to be the most dynamic demand component.

At this stage, the Danish authorities still maintain a somewhat more optimistic view on the likely increase in the volume of exports in 1985 than does the Fund staff, but to a marginal extent, these estimates may be influenced by the outcome of the ongoing negotiations on new wage agreements. Despite the more optimistic evaluation of export developments in 1985, the Danish authorities share the staff's view that the reduction in the current account deficit under present assumptions is likely to be small. Among the factors leading to a more pessimistic assessment by the Danish authorities are a higher exchange rate for the dollar, particularly influencing net interest payments, and a less optimistic view of export prices in the important areas of agriculture and shipping. Both these factors and the great difficulty inherent in an evaluation of the rate of growth of domestic demand mean that estimates of the outcome for the current account of the balance of payments for 1985 are surrounded by no small uncertainty.

However, in view of the Government's objective of eliminating the current account deficit by 1988--a target recently confirmed--the expected developments in the current account of the balance of payments in 1985 are giving rise to serious concern. On account of the unresolved wage and salary agreements, it is not possible to indicate at this stage in any detail what the political response to the more pessimistic balance of payments outlook will be. Since the Government is viewing the increase in industrial investment as a positive factor, any tightening of economic policy will in all likelihood aim at curbing the increase in consumption.

Extending his remarks, Mr. Fugmann explained that when the mediator postponed a strike, he did so on the assumptions that further negotiations would take place and that there was a possibility of reaching a negotiated agreement. While the postponement did not ensure that an agreement would be reached, it would bring more pressure to bear on the negotiating parties. As a result of the postponement, the strike would start one day before the beginning of the Easter holidays.

Mr. Schneider remarked that the strategy adopted by Denmark in late 1982 had been notably successful over the past two years. The economic situation had improved markedly owing to a gradual reallocation of resources from the household sector toward the private business sector, and to the improvement in the balance of payments which had been accomplished through fiscal restraint and domestic cost and price moderation. In particular, the discontinuation of exchange rate adjustments following a series of devaluations in the initial stages of adjustment and the increased reliance on an active incomes policy rather than exchange rate action to improve competitiveness had strengthened the recovery and broadened its base. That approach was effective and especially suitable to a small, open economy like that of Denmark.

Although adjustment policies seemed to have followed the same general pattern over the past two years, Mr. Schneider continued, the results were somewhat less satisfying, especially with regard to the balance of payments and domestic demand management. The external current account deficit as a percentage of GDP--which had decreased in 1983--had increased again in 1984. The annual percentage changes in domestic demand showed a similar pattern over that same period. Nevertheless, that development was not surprising; it could have been expected that the strategy adopted by the Danish authorities would occasion some growth in domestic demand--at least in the medium term--owing to the expected increase in private investment.

The transfer of resources from the household sector to the private enterprise sector and the envisaged improvement in the current account balance under stable exchange rates had affected the balance of payments situation in a complex way, Mr. Schneider observed. On the one hand, the increased profitability and greater investment opportunities for private enterprise at a time of world economic recovery had boosted investment but had also put pressure on imports. Although the momentum of investment had been maintained by the favorable outlook in export markets, the increased new investment had not yet had sufficient time to make any significant contribution to export earnings. On the other hand, to improve the current account position, public and private consumption had to be sufficiently checked to generate additional savings for new investment activities. Although public consumption had not increased in 1983 and 1984, private consumption--which amounted to more than half of GDP--had been relatively well restrained in 1983 but had risen strongly in 1984; according to Table 12 of the paper on recent economic developments, total disposable income had risen in real terms in 1984, but the annual percentage increase in private consumption had been much higher than that for private savings. As a consequence of the rapid growth in investment and private consumption, imports had grown faster than exports, resulting in a deterioration in the external current account.

Within the framework of the Danish economic strategy, the best course for redressing the external imbalance lay not in the management of overall domestic demand--as the staff had emphasized--but rather in the control of private consumption, Mr. Schneider continued. The crucial questions were thus how to reduce private consumption in order to enhance the financing of private investment, and how to increase total domestic saving to achieve financial balance. In that regard he offered four policy suggestions for consideration by the Danish authorities: first, a less accommodating stance of monetary policy, as advocated by the staff; second, a more flexible interest rate policy combined with an easing of the tax burden on interest income; third, a further tightening of fiscal policy in order to achieve the medium-term objective of eliminating the fiscal deficit by the end of the decade; fourth, the continuation of a firm incomes policy aimed at further wage restraint.

An earlier tightening of monetary policy in 1984 would have had a restraining effect on the growth of private demand, Mr. Schneider commented. In their conduct of monetary policy, the authorities should pay more attention to developments of the monetary aggregates in order to avoid delayed reactions. Greater reliance on a more flexible interest rate policy would also have a beneficial effect on the savings ratio: the after-tax level of interest rates was low, providing incentives for debt accumulation rather than for savings. The limitations placed on the autonomy of monetary policy by the authorities' commitment to the freedom of capital movements and to the maintenance of a fixed exchange rate did not preclude changes in the rate of taxation of interest income, which was still high compared with other countries. Moreover, that unfavorable differential in after-tax interest rates could induce Danish residents to keep part of their savings outside of the country to the detriment of the domestic savings capacity of the economy. As that issue had not been discussed in the staff papers, he invited comment by the staff or Mr. Fugmann. He also welcomed the Government's proposal to reform the income tax system in order to improve incentives.

As to public consumption and savings, Mr. Schneider noted, a policy of gradually reducing the budget deficit by increased emphasis on expenditure reduction had rightly been pursued, and the fiscal adjustment since 1982 had been remarkable. Over the past two years, the fiscal trend seemed to have become contractionary, particularly since the expenditure impulse had become negative for the first time in 1984. Despite the lowered budget deficit, which had increased the scope for public savings, the fiscal balance of the public sector remained negative by about 4.5 percent of GDP; nevertheless, it would not have been realistic to expect the public sector fiscal balance to be righted in so short a time. The Government's approach--using expenditure restraint to achieve approximate balance in the central government accounts by the end of the decade--had his full support; it would avoid deflating the domestic economy and further undermining the fiscal position. However, some additional fiscal measures might be needed, given the limited room for maneuver available. One possibility might be to raise indirect taxes, which at present accounted for only 35 percent of revenue; higher indirect taxation would tend to restrain consumption and stimulate saving.

Considering the authorities' present strategy of increased reliance on incomes policy to maintain a stable exchange rate, it was of the utmost importance to restrain wage increases in order to maintain the present strength of Denmark's competitive position, Mr. Schneider considered. Both the authorities and the staff had underlined the importance of the outcome of present wage negotiations for the future course of financial policies in 1985; he appreciated the remarks by the staff and Mr. Fugmann concerning recent developments in those negotiations and hoped that the mediators would succeed in avoiding a strike. He fully supported the authorities' reliance on wage restraint to preserve external competitiveness and commended them for their commitment to the free movement of capital and to the principles of free trade, as well as for their maintenance of high official development assistance.

In concluding, Mr. Schneider remarked, although the Danish authorities were striving to correct economic imbalances through appropriate adjustment efforts, by readjusting the emphasis placed on some aspects of their policies, the efficiency of the adjustment process could be enhanced. Moreover, further determined efforts would be required if the authorities were to achieve their goals within the time envisaged.

Mr. Wijnholds expressed agreement with the staff appraisal. The performance of the Danish economy since 1983 had indeed been impressive. The economic recovery in 1984 had been much stronger than initially expected--stronger also than in most other European countries--and had been concentrated in the private sector with rapidly increasing business investment. The overall fiscal deficit had been substantially reduced, from 8.75 percent of GDP in 1982 to 4.5 percent in 1984. Owing to a rapidly growing labor force, the considerable increase in employment had not yet led to more than a limited reduction in the rate of unemployment.

As a consequence of the rapid growth in domestic demand in 1984, the increase in export volume had been more than offset by an upsurge in imports, resulting in a weakening of the external current account, Mr. Wijnholds continued. As the Danish authorities' objective was to eliminate the current account deficit by 1988, he tended to agree with the staff that, for purposes of external adjustment, they would have to strengthen financial policies further. In that regard, Case A in the staff report indicated that, assuming an annual rise in domestic demand of 2 percent, the deficit would be eliminated only in 1990. Similarly, according to the most recent OECD country survey, apart from a growth of demand of no more than 2 percent annually, the elimination of Denmark's current account deficit by 1988 would require an annual improvement in the competitive position of almost 3 percent. At present, however, the annual growth of domestic demand was approaching 3 percent; according to the medium-term projections on page 18 of the staff report, the deficit in the current account would persist in those circumstances.

It seemed clear, Mr. Wijnholds noted, that the authorities were inclined neither to adhere to intermediate monetary targets nor to reduce drastically the ample money supply in view of their understandable desire to preserve the strong growth in investment. However, monetary expansion in 1984 had been twice the increase in nominal national income, despite the strong improvement in the monetary financing of the budget deficit. Mr. Fugmann's point was well taken that in a small, open economy the role played by monetary aggregates could be virtually taken over by the exchange rate, and that an important test of the adequacy of monetary policy was thus whether it had supported a stable exchange rate. The comfortable position of the Danish krone in the European Monetary System added strength to that argument. He would, however, submit that although the exchange rate was a necessary test, it was not a sufficient one; the other crucial test was the rate of inflation, which in Denmark seemed to be stuck at about 6 percent--a rate that did not compare favorably with those of trading partner countries. An important element in maintaining exchange rate stability in the medium term was no doubt the relative rate of price increase. Moreover, without exchange rate stability, the containment of inflation became even more burdensome in an open economy. Further efforts therefore seemed to be needed in order to reduce monetary expansion.

The staff had doubts about bank lending guidelines as an instrument of monetary policy, Mr. Wijnholds observed. Borrowing abroad by the corporate sector had greatly increased in close association with the use of that instrument, and the staff favored a more market-oriented approach, expressing the view that the sensitivity of capital flows to interest rates was not great. He invited the staff to explain more fully their viewpoint and also invited Mr. Fugmann to comment on that viewpoint.

On fiscal policy, Mr. Wijnholds commented, the authorities had acted courageously; their achievements were particularly noteworthy, considering that a minority Government was in office. However, there was yet a long way to go to reach the objective of eliminating the budget deficit by 1990. For 1985, the overall deficit was projected to decline to 3.25 percent of GDP. He agreed with the staff that, in view of the external objectives, that policy could prove to be insufficiently tight. A slower pace of economic growth and a subsequent slower reduction of the deficit might require more active adjustment measures. Given the high proportion of public expenditure in GDP as well as the increase in tax revenue in recent years, further restraint in expenditure would be preferable to revenue measures. Mr. Fugmann had made it clear, however, that in the present political constellation, expenditure cuts were unlikely.

Important progress had been made in wages, Mr. Wijnholds considered, with the continued suspension of wage indexation constituting a positive development. The present wage negotiations were of course crucial in the light of the authorities' commendable strategy to improve competitiveness through restraint in domestic costs rather than through exchange rate adjustment. As in other European countries, the demands for shorter working hours made those negotiations more difficult. Should the outcome be unfavorable from a macroeconomic viewpoint, the authorities would have to act swiftly and decisively in adopting demand management policy to prevent their economic strategy from being seriously eroded.

Mr. Coumbis stated that he agreed with the thrust of the staff appraisal. During the Executive Board's discussion of the 1983 Article IV consultation with Denmark (EBM/84/20, 2/18/84), Directors had generally agreed that the authorities' short-term policies had been successful in bringing down inflation and reducing the current account deficit. Moreover, it had been generally accepted that the medium-term targets and objectives were appropriate to address effectively the internal and external imbalances of the economy. More specifically, the authorities' objective of eliminating the current account deficit in three to four years and the public sector deficit by the end of the decade was necessary to decrease net foreign debt--at 37 percent of GNP in 1984--to more viable proportions.

Developments in 1984 had, however, been mixed, Mr. Coumbis continued. The authorities had successfully increased the profitability of industries by decreasing unit labor costs and increasing demand. As a result, investment in 1984 had increased by 25 percent, real GDP by 4.5 percent, and employment by 3.5 percent. There had, however, been no substantial decline in the rate of inflation, and the current account balance--which had been expected to fall from 2 percent of GDP in 1983 to 1.5 percent in 1984--had risen instead, to about 3 percent.

In 1984, Mr. Coumbis remarked, there had been a spectacular increase in private investment, which showed the responsiveness of the private sector to measures increasing the profitability of private industries. Moreover, industrial exports, excluding ships and aircraft, had increased in value by 19 percent, indicating the continued strong competitive position of Danish industry. The suspension of wage indexation for two more years--to July 1987--was a remarkable achievement that would help the authorities to maintain the profitability and competitiveness of the industrial sector. Public sector deficits, excluding interest, had decreased for the second year, and the deficit was expected to be about 4.5 percent of GDP, compared with 8.75 percent in 1982. The policy of fiscal restraint, implemented by keeping noninterest expenditure unchanged in real terms, was expected to continue in 1985. As a result, the fiscal deficit was expected to be reduced further to about 3 percent of GDP.

During their discussion of the 1983 Article IV consultation, Mr. Coumbis recalled, Executive Directors had expressed concern that excessive monetary expansion could jeopardize the improvement in the external account and in the rate of inflation. Interest rates had been allowed to decline from 20 percent in 1982 to 13.5 percent in 1983, while broad and narrow money had increased by about 25 percent. According to the authorities, the major part of the monetary expansion in 1983 had reflected a once-for-all adjustment of money demand to lower interest rates and lower rates of inflation. However, during 1984, broad and narrow money had expanded by 18 percent--a rate well above the increase of nominal GDP. A study by the staff on the demand for money had found that the decline in interest rates and in the rate of inflation could explain only part of the monetary growth in 1983 and 1984. Therefore, in his view, the authorities should re-examine credit policies with a view to establishing targets more consistent with the adjustment policies followed by the authorities in other areas.

With regard to credit policy, Mr. Coumbis added, the staff had raised two issues: the need to use intermediate targets such as the growth of money and credit instead of final targets; and the need to introduce a new mechanism with more traditional tools of monetary control to replace the present system of lending guidelines and the relevant sanctions, which created distortions in the banking system. He agreed with the staff on both points, and noted that the use of intermediate targets had many advantages--among others, it would provide timely indications of monetary developments, thereby making prompt corrective measures possible.

Economic developments in 1984, Mr. Coumbis commented, especially in the current account deficit, indicated that both fiscal and credit policies in 1985 should be more restrictive than in 1984 in order to bring the economy back on track. Moreover, policy strategies that the authorities were planning to follow in the medium term in order to nullify the current account deficit and the fiscal deficit up to 1990 would have to be made more comprehensive. He would like to know from the staff or Mr. Fugmann if the authorities were planning to alter their policies for 1985 based on more recent information concerning the strength of domestic demand and the competitive position of Danish industries.

As for medium-term strategy, Mr. Coumbis noted, the authorities and the staff had developed a number of models and scenarios using simulation techniques and sensitivity analyses of the major variables. First, medium-term projections were sensitive to changes in the rate of growth in industrial countries. Table 6 of the staff report showed, for example, that if the growth in the industrial countries were 1 percent lower than in the basic model, the ratio of the current account deficit to GDP in 1990 would deteriorate by 2 1/4 percent of GDP. Second, the authorities' strategy of reducing the public sector deficit gradually by keeping expenditures constant in real terms might fail to nullify public sector deficits by the end of the decade if interest rates abroad and at home failed to decrease substantially. Third, the success of the authorities' general strategy in the medium term to grow the economy out of debt depended crucially on their ability to keep domestic wage increases lower than those in other competitive industrial countries. Fourth, developments in private investment in 1984 had shown how responsive the private sector and investment activity were to various stimuli provided by the authorities. Such responsiveness required that the authorities develop early-warning indicators of economic activity and be ready to change their policies as soon as they detected changes in the economic environment.

In concluding, Mr. Coumbis commended the Danish authorities for remaining committed to liberal trade policies and for maintaining a level of official development assistance above the UN target, despite the difficult economic situation that they were facing.

Mr. Templeman remarked that the economic adjustment policy of the new Danish Government in 1982 had embodied two priority goals: an improvement in Denmark's competitiveness through domestic cost restraint within a relatively fixed exchange rate regime, and a shift of resources to the private sector through fiscal restraint. Those targets were intermediate, the final objective being economic growth with price stability in the context of a sustainable external position. Some macroeconomic figures illustrated the impressive achievements. Real GDP had risen by nearly 4.5 percent in 1984, compared with declines in 1980 and 1981; real gross fixed investment had increased by over 12 percent, compared with negative 17 percent in 1981; both consumer prices and nominal wage earnings in manufacturing had eased in 1984 to the 5-6 percent range, compared with 10-12 percent in 1981; and employment in the private sector had risen by 3 percent or more, compared with a decline of 2 percent in 1981. Employment growth had been particularly heartening and was no doubt related to an impressive recovery of profits, as Chart 3 of the staff report illustrated. However, following initial success in reducing the ratio of the current account deficit to GDP, that ratio had increased in 1984, and the inflation gap between Denmark and other industrial countries remained significant.

Looking ahead, Mr. Templeman noted, the authorities aimed at further progress on competitiveness, leading to the achievement of balance in the current account of the balance of payments by 1988 and a further shift of resources to the private sector from the public sector by achieving balance in the Central Government's budget by 1990. In both those areas, success appeared possible; nevertheless, there were some potential roadblocks along the way. To meet the current account goal, either a further improvement in cross-competitiveness between Denmark and its trading partners would be required--which had not been recently achieved--or else domestic demand would not be able to grow as fast as in other countries. To achieve the fiscal target, maintaining expenditure constant in real terms might not be sufficient, if a revenue shortfall occurred as a result of overoptimistic assumptions concerning the rate of growth of the economy and of tax revenue.

As to increased competitiveness, Mr. Templeman observed, although good progress had been made in reducing the rate of growth of prices and wages, an unfavorable gap remained between Denmark and other industrial countries, as shown in Chart 4 of the staff report. The slow decline in real wages beginning in early 1982 had no doubt played an important role in better inflationary performance. However, it also pointed to the difficulty of continuing wage restraint, despite the further suspension of wage indexation until the spring of 1987. The staff had correctly stressed the importance of moderate wage settlements in 1985; the information on wage negotiations reported by the staff illustrated the extent of the difficulty. Yet continued restraint would be particularly important in the context of relative exchange rate fixity under the European Monetary System. Although good progress had been made in restoring Denmark's international competitive position by 1982, and the rather steady increase in export market shares was encouraging, the current account had worsened perceptibly with the acceleration of economic growth in 1984. The foreign debt situation left little room for temporary reversals. The staff's medium-term scenario--which assumed that domestic demand would rise by 1 percent less in Denmark than abroad in the period 1986-90--would result in modest achievements in the balance of payments and debt: for example, the current account balance would move from a deficit of 3 percent of GDP in 1984 to balance in 1990; the ratio of net debt to GDP would decline from about 38 percent to 32 percent; and the net debt service ratio would drop by only about 1 percent, from 23 percent in 1984 to 22 percent in 1990. The Danish authorities had suggested that, if wage increases in Denmark were only 2 percentage points lower than those abroad, a faster rate of growth could be achieved, but such cost performance had not yet been achieved and would be difficult to accomplish in the future.

As to the prospect of a further shift in resources to the private sector through fiscal restraint, the staff had pointed out that the reduction in negative public sector savings had not yet been sufficient to finance the rise in domestic investment, Mr. Templeman noted. Spending restraint had been quite good, including restraint on social transfer payments--a politically sensitive issue everywhere. But the steady growth of interest payments had added to the burden of adjustment placed on revenue growth and expenditure restraint in other areas. While the ratio of noninterest expenditures to GDP was 5.3 percent lower in the 1985 budget than in 1982, the rise in interest payments had reduced the overall gain from expenditure reduction to only 1.8 percent of GDP. Not only were the medium-term prospects for reaching fiscal balance by 1990 in doubt, but, in the shorter term, the staff had suggested that tighter fiscal restraint might be needed in 1985 if there were no early evidence of a strengthening of the current account and if wage settlements proved to be excessive. He invited the staff to elaborate on that point.

The proposal to modify the personal income tax rates to improve incentives was welcome and would reduce tax rates for a substantial number of taxpayers, primarily in the middle bracket, where the rate was at present 60 percent, Mr. Templeman continued. The rates in the proposed new income tax brackets--at 48 percent and 68 percent--were, however, striking; such figures underlined the high tax burden in Denmark, which was also reflected in an expected ratio of public sector revenues to GDP in 1985 exceeding 48 percent.

On monetary policy, Mr. Templeman observed, Chart 10 of the paper on recent economic developments showed high real interest rates in the range of about 6.5 percent to 8 percent during 1984. Nevertheless, high tax rates substantially reduced the after-tax return and lessened the incentive to domestic savings and capital inflows. As to the best measures of the adequacy of monetary policy, he tended to favor the argument that the final macroeconomic objectives--not the immediate or intermediate monetary targets--provided the best test. However, the staff's argument that it was dangerous to await evidence on macroeconomic performance before making adjustments in monetary policy was persuasive: experience with inflation and balance of payments performance in 1984 offered a warning against delays in policy response.

In concluding, Mr. Templeman commended the Danish authorities for good performance in recent years and supported their efforts to balance the fiscal and external accounts over the coming few years. Progress had, however, slowed in 1984 while economic performance in Denmark's trading partners had improved; it was therefore important that, in the future, policy decisions be taken promptly if economic performance deteriorated.

Mr. Goos noted the progress that the Danish authorities had made in several areas, in particular the strong resumption of private investment and real growth, the reduction in the public sector deficit, and the apparent improvement of profitability in the manufacturing sector. Their success in restoring Denmark's international competitiveness by moderating domestic cost pressures rather than by recourse to exchange rate action--without placing major strains on the country's social fabric--was also noteworthy. Two major areas of concern remained, however: the continuing high rate of unemployment, and the renewed increase in the balance of payments deficit, which had considerably surpassed original expectations. Moreover, it would be unfortunate if the favorable overall performance of the economy were brought to a standstill or reversed by inappropriate wage settlements.

On fiscal policy, Mr. Goos commended the authorities for having reduced the public sector budget deficit and noted with satisfaction their intention to further reduce the share of Government in economic activity in 1985. Table 3 of the staff report revealed that the policy effort so far had placed more emphasis on restraining expenditure than on raising revenues. Recourse to a revenue increase was certainly appropriate because of the overriding need to reduce the deficit; nevertheless, in the future, the authorities should adopt a policy course that concentrated more on expenditure restraint. In that context, he welcomed the planned tax reform, which should strengthen private initiative and stimulate domestic savings. Since the structure of taxes on interest rate payments and revenue was to be changed, he wondered whether that reform would enlarge the room for maneuver of monetary policy; he would welcome comments by the staff or Mr. Fugmann on that matter.

The authorities had expressed their intention to eliminate the external deficit by 1988 and the fiscal deficit by 1990, Mr. Goos observed. However, given both the strong performance of investment and the disappointing performance in the external accounts, he wondered whether the public sector should not release savings at a much faster rate. That would call for further restraint in fiscal policy.

There was considerable disagreement between the staff and the Danish authorities on the appropriate course of monetary policy, Mr. Goos noted, and he welcomed the frank and open discussion of that disagreement in the staff papers as well as in Mr. Fugmann's opening statement. On the one hand, Denmark had achieved considerable progress on the monetary front: the inflation rate had been brought down considerably, and the exchange rate had been remarkably stable. On the other hand, the staff had presented a number of valid points that warranted consideration; for example, the inflation rate had remained above the rates in other industrial countries and also above previously expected rates. The deficit in the current account of the balance of payments had doubled, indicating the need to contain domestic demand. Moreover, the growth of broad money--even though it had receded from its record level in 1983--was again on a rising trend, and the growth rates of other monetary and credit aggregates were also above the growth rate for nominal GDP, which, if continued, might rekindle inflation and further aggravate external pressures. Nevertheless, his authorities tended to agree with the Danish authorities' assessment of the monetary policy stance--at least with respect to recent performance. Monetary policy would, however, have to pursue a cautious and, given the recent developments on the wage front, rather restrictive stance in order to contain and reduce inflationary pressures.

The staff report had left the impression that fiscal and monetary policies were being conducted in a rather defensive way, Mr. Goos remarked. Specifically, the Danish authorities seemed to have assumed a wait-and-see attitude toward adopting more restrictive policies if warranted by inappropriate wage developments. That strategy was not without risks. It might take some time to react to inappropriate wage developments; meanwhile, imbalances could arise that might be more difficult to tackle later than they would have been if a precautionary fiscal policy stance had already been in place. In his view, macroeconomic policies should be given a stronger role as a guidepost to decision making in the private sector. While that assessment may not do full justice to the actual conduct of policy in Denmark, particularly given the political constraints under which the Government had to operate, he believed that the process of wage determination might be greatly helped if it were to take place in a framework of more determined macroeconomic guidance. In sum, the recent achievements of the Danish authorities were certainly commendable, but, like the staff, he considered that there was a continuing need for restrictive wage and financial policies and perhaps a need for a further tightening of such policies in view of the weak external sector and present wage settlement difficulties.

Mr. de Maulde remarked that economic performance in 1984 confirmed that the strategy pursued over the past two years--aimed at reducing inflation, improving the current account, and bringing down the budget deficit--was bearing fruit. In particular, he welcomed the slowing of the rate of inflation, which had narrowed the differential vis-à-vis Denmark's main trading partners; the increased profitability, which had, in turn, boosted business investment and employment; and the sharp reduction in the public sector deficit to 3 percent of GDP, compared with almost 9 percent in 1982. Nevertheless, the deterioration of the external current account in 1984 and the widening of the deficit to 3 percent of GDP, with unavoidable consequences on foreign indebtedness, which--at 37.5 percent of GDP--had risen to a high level for an industrial country, were worrying.

The authorities' objectives, Mr. de Maulde observed, were to correct the current account imbalance while maintaining the level of activity needed to correct the rate of unemployment and continue the fight against inflation. The pursuit of those objectives implied the continuation of firm demand management policies and the implementation of some structural reforms in the economy. The staff recommendations in that respect appeared to be appropriate, with the nuances introduced by Mr. Fugmann in his opening statement.

On public finances, Mr. de Maulde remarked, the authorities' intention to eliminate the deficit by 1990 was welcome, and should result in savings for the private sector. Developments in 1984 had been satisfactory. The budgetary deficit had been lower than expected--thanks in part to the buoyancy of the economy--and in part to the Government's determination to contain public expenditure. However, the 1985 budget was still clouded with uncertainties, as agreement on further expenditure cuts was unlikely. In order to respond to possible unfavorable developments, the authorities should consider other courses of action, including an increase in taxes, although he recognized that the already high tax burden might limit their flexibility. Noting the staff's allusion to the introduction of a tax reform, he invited elaboration on that subject.

As to monetary policy, Mr. de Maulde commented, Mr. Fugmann's arguments were convincing, particularly his statement that the role played by monetary aggregates in a large, self-contained economy was essentially taken over by the exchange rate in a small, open economy. However, the staff's point was also well taken that the adoption of intermediate targets would have clear advantages, allowing the authorities sufficient room to take corrective action in the event of rapid monetary expansion.

Achieving balance in the current account clearly required an improvement in the competitiveness of Danish goods and services, Mr. de Maulde considered. Instead of following the dangerous path of exchange rate adjustment, the authorities had exercised domestic cost restraint. The results had been encouraging: profit margins had been restored, and investment had begun to pick up. The authorities' decision to suspend wage indexation in the spring of 1987 also appeared to be particularly appropriate. However, major doubts remained as to the outcome of wage negotiations, as the staff had noted. In any event, owing to the uncertainties surrounding the evolution of world markets, particularly for agricultural products, the overall restrictive stance of policies would have to be maintained. Mr. Fugmann had indicated that since the increase in industrial investment was a positive factor, any tightening of economic policy would in all likelihood aim at curbing the increase in consumption; that policy seemed sensible, but delicate to implement to the extent that the wage settlement exceeded the authorities' wishes.

In concluding, Mr. de Maulde commended the Danish authorities for their active stance in official development assistance.

Mr. Ainley commended the authorities for the impressive turnaround in the Danish economy over the past two years. Their two-pronged strategy of improving competitiveness and shifting resources to the private sector had worked extremely well. The recent rapid growth in business investment was particularly encouraging. Most of the main indicators were currently moving in the right direction, and confidence had been restored.

On the other hand, Mr. Ainley noted, inflation remained high compared with other industrial countries, and unemployment was still about 10 percent. The deterioration in the balance of payments was also disappointing, particularly in view of Denmark's relatively high external debt. He shared the authorities' hope that the deterioration was only a temporary setback; nevertheless, the uncertain short-term outlook for the current account was worrying. The authorities should therefore maintain their adjustment efforts, both in the short and medium terms, if they were to achieve their objectives of eliminating the fiscal and external deficits by the late 1980s.

Achievement of those objectives would require continued improvements in Denmark's competitiveness, Mr. Ainley added. In turn--given Denmark's participation in the European Monetary System--such improvements depended on moderate wage settlements; he therefore welcomed the decision to suspend wage indexation until early 1987. The staff and Mr. Fugmann had indicated that the outcome of the 1985 wage negotiations was still uncertain, and that there was at least a risk that they would break down. Could the staff or Mr. Fugmann indicate whether the Government's 3.5 percent to 4 percent wage guideline was still within reach? After all, that would have an important bearing on the appropriate stance of financial policies, which were to some extent being put on hold until the negotiations were completed.

On the fiscal side, Mr. Ainley endorsed the authorities' commitment to continued restraint. Their comprehensive moves to reduce public expenditure--which still accounted for a relatively high proportion of GDP--were particularly welcome, as were the proposed tax reforms, for the reasons previously mentioned by Mr. Schneider. Further tightening might be required if wage settlements turned out to be higher than the Government expected. Considering the already high tax burden, firm control over expenditure in the medium term would be essential if the central government deficit were to be eliminated by 1988.

Noting the differing views of the staff and the Danish authorities on the appropriateness--both past and present--of the monetary stance, he agreed with Mr. Fugmann that monetary policy had not led to any weakening of the exchange rate, and that the autonomy of monetary policy was necessarily limited in Denmark's circumstances, Mr. Ainley remarked. However, the staff's view--that continued, rapid growth of the monetary aggregates at the present rate could make it difficult to bring inflation down further and could also jeopardize the desired improvement in the external accounts--was also valid. The recent moves to restrain bank lending were appropriate. Nevertheless, he had reservations about the reliance on lending guidelines, which appeared complex and--according to the paper on recent economic developments--had led to evasion. In that regard, he invited the staff and Mr. Fugmann to elaborate on the reference made in the staff report to the possible introduction of new mechanisms of monetary control.

Finally, Mr. Ainley commented, he was encouraged to note that the authorities had not waivered from a liberal trade policy in the present, difficult international environment. He fully agreed with them that an open trading policy was an important instrument to achieve structural adjustment. He also commended their good record on official development assistance (ODA), together with their intention to keep ODA above the UN target over the next five years.

Mr. Leonard generally agreed with the staff's report on the Danish economy. Progress toward greater economic balance had been uneven in 1984 compared with the two preceding years: with the rise in domestic demand, the current account deficit had widened, consumer price increases had dipped only slightly below the rate of 1983, and hourly earnings in manufacturing had strengthened. At the same time, some real benefits had accrued: agricultural, manufacturing, and construction output had increased significantly; the overall rate of growth of GDP had more than doubled; the value of exports had expanded strongly for the second consecutive year. There had been a welcome increase in employment as the labor force had continued to expand. Moreover, the public sector deficit had been further contained.

It was still doubtful, Mr. Leonard considered, whether economic trends were firmly set in the direction of reaching the Government's objectives of eliminating the external deficit by 1988 and the fiscal deficit by 1990. It was also doubtful whether in pursuing those objectives the authorities would also be able to promote more employment and a return to rising standards of living and welfare that had marked the economy's performance in the past.

The most crucial area in that regard was wage policy, Mr. Leonard continued. The Danish system of industrial relations had demonstrated that hard wage bargaining did not have to mean economic and social confrontation and could result in higher real pay for workers, combined with general national progress. The operation of the system had, however, deteriorated over the past decade, and at present it appeared that the Government--both in the direct management of its fiscal affairs and in the general management of the economy--was seeking to restore the system to its previous strategic role in national development. Mr. Fugmann's statement suggested that the Danish authorities had a particularly delicate task to perform, at once leaving the wage negotiation process directly in the hands of the social partners, while influencing outcome of the negotiation by pursuing a firm line in public sector pay, maintaining economic buoyancy, and preserving the social milieu. If the authorities were successful, and if the claim for shorter working hours in particular did not lead to a loss of external competitiveness, the foundation for balanced economic growth in the future would have been largely secured.

The Government had shown considerable resolution in reducing the fiscal deficit by limiting the growth of public sector pay and freezing most social transfers, excepting social pensions, Mr. Leonard remarked. Moreover, the Government intended to reduce the deficit further by holding noninterest expenditure at about current real levels and by looking to revenue buoyancy to close the gap. The maintenance of Denmark's competitiveness was clearly important; consequently, if all did not go well in the current pay negotiations, the burden of taxation would ultimately have to be increased even more than at present; Mr. Fugmann seemed to envisage such a possibility. It would also be desirable to tighten the fiscal stance by cutting expenditures; current public expenditure, excluding interest payments, was high--over 40 percent of GDP--and there should be room for some pruning.

As to monetary policy, Mr. Leonard noted, credit expansion had to be pitched at the right rate in operational terms to ensure that the appropriate degree of liquidity was in fact maintained. It would be unfortunate if monetary policy were to become more generous than necessary; any laxness at present could easily be misinterpreted by the social partners in their pay negotiations. He therefore considered that the staff had appropriately emphasized the use of intermediate targets that would allow a prompt official response to untoward developments. He wondered whether there were special reasons why the authorities were not using a system of required reserves with the Central Bank as a means of offsetting capital inflows that seemed likely to upset monetary objectives, and invited Mr. Fugmann or the staff to comment on that question.

Mr. Clark said that Denmark had made a good start in restoring better fiscal and external balance to the economy, but clearly much remained to be done. He strongly endorsed the Danish authorities' aim of eliminating the external deficit by 1988 and achieving approximate balance in the fiscal position by the end of the decade. It seemed likely, however, that further measures would be required if those goals were to be achieved. Although the authorities appeared prepared to tighten their policies if necessary, they seemed to differ with the staff about the timing for the implementation of adjustment measures. Against the background of a persistent current account deficit, rising external debt, relatively high inflation, and uncertainty over wage restraint and competitiveness, he was inclined to agree with the staff that more timely action would be needed to keep the adjustment process on track.

The reduction in the net borrowing requirement of the Nationalbank in 1984 and the proposed continuation of fiscal restraint in 1985 were welcome, Mr. Clark commented. Moreover, because of the uncertainties already mentioned, the authorities should consider tightening fiscal policy further rather than awaiting the external current account outcome for 1985 and the conclusion of the wage negotiations currently under way. Part of the recent improvement in government revenues was attributable to the buoyancy of economic activity, reflected in higher corporate profitability and high domestic demand; however, external pressures could lead to a fall in profitability, and current account constraints could cause the authorities to act to restrain domestic demand. Moreover, half of the reduction in the public sector deficit in 1985 reflected a once-for-all adjustment--the bringing forward of PAYE payments. Furthermore, any additional measures should concentrate more on expenditure than on revenue. In Denmark, the ratio of public expenditure to GDP--at about 50 percent--was among the highest in the European Communities, while the average marginal income tax rate was extremely high and ran a great risk of damaging incentives.

He shared the staff's concern about the rapid growth of the monetary aggregates relative to nominal GDP and agreed that, in view of the buoyancy of domestic demand and current account prospects for 1985, early and additional tightening of monetary policy would be appropriate, Mr. Clark continued. In view of the authorities' reservations about monetary targets, he wondered whether they had reviewed the possibility of monitoring domestic credit exansion (DCE). In that regard, at least until recently, DCE had been higher than monetary growth. Whatever conclusion was reached concerning monetary targets, he encouraged the authorities to adopt a more market-oriented approach to credit control so as to avoid the distortions associated with the present system of credit rationing. In that context, he welcomed the indication in the staff report that the authorities were giving thought to new mechanisms of monetary control.

It was disappointing that no improvement in the current account in 1985 over the outcome for 1984 was foreseen, Mr. Clark commented. External adjustment would be jeopardized if domestic demand continued to increase faster in Denmark than in its trading partners; moreover, the authorities' calculations were based on a wage assumption that might prove optimistic. He wondered whether the staff agreed with the authorities that the setback in the current account performance in 1984 had been temporary. In that context, he recalled the view expressed by Governor Hoffmeyer in November 1984, that the balance of payments was in a grave "interest rate trap," which would require a rate of growth of exports of 3 percent simply to meet the increased burden of interest payments in 1985, given unchanged interest and exchange rates.

As to wage policy, Mr. Clark observed, there were disturbing signs that the Government's guidelines might not hold. Several factors, such as improved corporate profitability, successive falls in real wages, higher than projected inflation at the end of 1984, and union demands for shorter working hours, were encouraging higher claims over the next two years; he understood, for example, that one union's wage demand had been as high as 10 percent. That demand was worrisome in view of the central position of wage restraint in the authorities' external strategy.

Finally, he invited further comment from Mr. Fugmann or the staff on three points, Mr. Clark remarked. First, regarding unemployment, did the authorities agree with some commentators that adherence to the 2 percent wage guideline would be needed to bring about a moderate decline in unemployment--from about 10 percent to 7.5 percent--by 1990? Moreover, did the authorities envisage measures beyond those referred to in the paper on recent economic developments to reduce youth unemployment? Second, concerning the exchange rate and Denmark's competitiveness, he would be interested in knowing more about the krone's position--which had been very strong since October 1984--in relation to the deutsche mark, considering Denmark's close trading and investment links with Germany. Third, considering the vulnerability of exports to competition from low-cost producers, he would have liked to see more attention given to the structure of exports in the staff papers.

Mr. Mtei noted that a number of positive developments had taken place in the Danish economy in recent years: economic activity had been buoyant in 1984, with real GDP growing by 4.3 percent; industrial production was on the rise; the rate of inflation measured by consumer prices was half that prevailing three years earlier; and the declining trend in the public sector deficit was continuing. Only two problem areas remained: the current account deficit had unexpectedly risen slightly, and the rate of unemployment remained high at about 10 percent.

The outlook for the future was encouraging because the Danish authorities not only were aware of the need to continue the adjustment process, but were in fact implementing measures aimed at consolidating the gains achieved so far, Mr. Mtei continued, as was quite evident in fiscal policy, which would be crucial to maintaining a stable economic environment in the medium term. As to the continued trend toward fiscal equilibrium, two points were noteworthy: first, the improvement in the budget had come about not only through increased revenue--which indeed had been helped by the robust performance of the economy--but also through the Government's commitment to containing the growth in expenditures. Moreover, that expenditure restraint had been exercised in politically sensitive areas such as social transfers and wage settlements for the public sector. In that regard, the Government's decision to extend the suspension of the wage index system for two more years until the spring of 1987 was particularly noteworthy; in his view, the indexation system should be abolished--considering its potential to fuel inflation--while continuing efforts to ensure that the benefits derived from such a move were not eroded by attempts by labor to reduce the work week. Second, interest payments--which had grown from less than 1 percent of GDP in 1981 to over 5 percent in 1985--imposed a major constraint on achieving more rapid adjustment in the financial position of the public sector. In the circumstances, efforts should be continued to reduce the borrowing needs of the Government, which in turn would give added flexibility to fiscal policy in the medium term.

Monetary policy should remain supportive of the general restrictive stance of fiscal policy and of the objective of improving Denmark's external payments position, Mr. Mtei considered. Despite the concern expressed by the staff at the rapid growth of money and credit over the past two years, he understood the authorities' position on the role of monetary policy in a small, open economy such as Denmark's, as well as the conflict that sometimes emerged in the application of that policy when a government embarked upon growth-oriented policies in the face of a weak external position. In that connection, although the upsurge in demand in Denmark posed a problem for the external sector--at least in the short run--the balance of payments might improve in the long run, considering that growth in investment, particularly in terms of expanding the productive capacity of the export sector, was an important feature of the revival in economic activity. That was more likely to occur if the authorities succeeded in improving the competitiveness of the Danish economy.

The authorities' goal was to eliminate the current account deficit by 1988; the staff report predicted a deficit equivalent to 3.75 percent of GDP for 1985, Mr. Mtei observed. He would be interested in learning what the staff considered a sustainable balance of payments scenario for Denmark over the medium term. More generally, should the elimination of the country's current account deficit--or, for that matter, the budget deficit--necessarily be the goal of economic policy?

In concluding, Mr. Mtei commended the Danish authorities for their continued commitment to free trade, their efforts to speak out against protectionism--even beyond their borders, the maintenance of development assistance above the UN target, and the emphasis placed on assistance to low-income countries.

Mr. Jayawardena remarked that, after facing the economic difficulties following the rise in oil prices, the Danish authorities had adopted an anti-inflationary stance toward demand management, relying largely on fiscal and income restraint and--on the supply side--on measures to liberalize the economy. That policy had yielded good results in 1983. In 1984 the recovery had strengthened and broadened its base, led by a sharp recovery in fixed investment in manufacturing. Real GDP growth in 1984 had been 4.3 percent; consumer price inflation had been contained at 5.6 percent--a rate somewhat higher than that prevailing among Denmark's major trading partners; the public sector deficit had been brought down from 8.5 percent of GDP in 1982 to 4.5 percent in 1984. The external current account deficit had weakened, however, probably on account of growth in domestic demand following an easing of monetary policy during the recovery; unless monetary policy were tightened further, a more dynamic exchange rate policy might be required. Observing the different emphasis placed by Mr. Fugmann on the question of monetary policy versus exchange rate policy, he looked forward to hearing the staff's comment on that issue. On another topic, unemployment remained stubbornly high despite economic recovery, probably reflecting deep-rooted structural problems, lying mostly in the fiscal area.

He commended the authorities for their strong commitment to an open trading system, Mr. Jayawardena continued. As noted on page 67 of the report on recent economic developments, Denmark was one of the leading industrial countries that had taken a highly antiprotectionist stance. The authorities had successfully resisted domestic protectionist tendencies and had strongly advocated freer trade in the GATT and within the European Communities. However, it was regrettable that, in view of Denmark's membership in the Communities, the Danish authorities had adopted the highly restrictive antitrade measures of the Communities, which substantially affected the export potential of developing countries. According to Table V.26 in the statistical annex of the staff report on trade policy issues and developments (SM/85/60, Sup. 2, 2/25/85), those measures included import licensing of leather and footwear, quantitative restrictions and voluntary export restraints on garments, minimum price undertakings on iron and steel, global quotas on jute, silk, textile fibers, carpets, rugs, and coir mats and matting. He hoped that the Danish authorities would be able to persuade their trading partners of the pernicious effects of those measures on the developing world.

In concluding, Mr. Jayawardena noted, Denmark had one of the best records in the world on official development assistance (ODA). Net disbursements of ODA had amounted to 0.77 percent of GNP in 1982, 0.73 percent in 1983, and 0.76 percent in 1984. Planned disbursements for the five years 1985-89 amounted to 0.77 percent of GNP annually, exceeding the UN target of 0.7 percent of GNP. Moreover, low-income countries had received over 80 percent of Denmark's bilateral assistance, mostly in the form of grants. Clearly, Denmark's commitment to international cooperation, as evidenced by its record, was exemplary and outstanding. He expressed the hope that Denmark's commitment to aid and free trade would be emulated by its trading partners.

Mr. de la Herrân commended the Danish authorities for their success in achieving an impressive economic recovery. Growth in 1984 had been higher than expected, reaching 4.5 percent. That growth was based on a fast and strong recovery of private investment and more buoyant private consumption owing in part to a significant increase in total employment. Such results demonstrated how a clear and steady strategy aimed at improving competitiveness through moderation in overall labor costs, combined with a significant reduction in the public deficit, could lead to a substantial improvement in investment and employment. The success of the economic recovery was partially eclipsed by a poor performance on the external side, where the worsening of the current account deficit had contributed to enlarging the already considerable external debt.

On the fiscal side, Mr. de la Herrân remarked, performance had been excellent, resulting in a reduction of the fiscal deficit in relation to GDP by 4.2 percentage points over the past two years, largely as a result of an increase in revenues--by 3.3 percentage points--rather than a cut in expenditures--by 0.9 percentage points. He therefore noted with concern Mr. Fugmann's indications that the authorities would encounter difficulties in achieving additional tightening of the 1985 budget through further expenditure cuts. Considering the already high share of public expenditure in GDP, additional increases in the tax burden could jeopardize the recovery, thus reducing the role of the private sector.

Regarding monetary policy, Mr. de la Herrân commented, the main monetary aggregates had clearly grown at rates well in excess of nominal income. Although, as Mr. Fugmann had pointed out, that expansion had not yet had an adverse effect on the exchange rate, it did not contribute toward the goal of achieving better behavior of the external current account, the main concern for the Danish economy.

The positive effects of the suspension of wage indexation on competitiveness and employment during recent years had been clearly demonstrated, Mr. de la Herrân noted. He welcomed the Government's action to extend for two additional years the suspension of the automatic cost of living adjustment of wages and salaries, which would ensure a decrease in unemployment.

In concluding, Mr. de la Herrân warmly commended the authorities for their commitment to development aid, despite their mounting budgetary difficulties.

The staff representative from the European Department, commenting on monetary policy, stressed that the judgment of the staff had not been based solely on developments in money and credit aggregates but rather on the buoyant development of demand--largely unforeseen by the authorities--which had led to a much more vigorous domestic recovery and a doubling of the current account deficit relative to the initial forecast in 1984. However, the staff believed that the strength of domestic demand and the strong expansion of money and credit were related.

The authorities had taken the view that the most important test of monetary policy was whether it had supported a stable exchange rate, the staff representative continued, and therefore they felt reassured given the recent behavior of the krone. The staff agreed that the behavior of the exchange rate could and should be used as an indicator of the stance of monetary policy, but given the variety of influences on the exchange rate, such an assessment should be made with caution and in the light of other indicators as well. Although such matters were not easy to judge, the staff considered that some of the factors behind the recent strong capital inflows into Denmark might be temporary; part of the inflow might be a portfolio adjustment by international investors following the exchange liberalization measures, and part might be related to the influence of the lending guidelines in diverting borrowing abroad. Thus, the interest sensitivity of capital flows appeared not to have undermined monetary policy--a judgment with which the authorities had agreed. In those circumstances, it became particularly problematic to view the short-term firmness of the exchange rate as evidence of the appropriateness of monetary policy. Other factors, such as inflation differentials or movements in the current account, suggested that the krone might not be fundamentally strong.

The authorities had suggested that greater attention be given to the behavior of rates of interest than to financial aggregates, the staff representative added. It was however particularly important in that regard to take into account the treatment of interest in Danish taxation. After-tax, real interest rates had remained fairly low. Although there was no evidence that that had led to recorded or unrecorded large capital outflows, it had, in the staff's view, boosted the demand for credit and reduced domestic savings. Tax reform should help in that area.

The authorities had also stated that the rates of monetary expansion were particularly difficult to assess in Denmark because the dividing line between monetary and nonmonetary assets was blurred, the staff representative explained. That was true for many countries and was one reason why the staff's judgment had been based on developments in domestic demand and the policies behind it. Thus, monetary policy was assessed first in terms of the objectives of policy--such as demand and the current account--and then with regard to various indicators such as the rates of monetary expansion, interest rates, and the exchange rate. It was of course true that more weight was placed on monetary aggregates by the staff than by the authorities.

As to the lending guideline system, the staff representative noted, the staff had discussed its effectiveness with the Danish authorities, who were aware of some of its pitfalls. At present, they were actively considering a move in a different direction, including the staff's suggestion of a move toward, for example, a cash reserve system with open-market operations.

On fiscal policy, the staff representative indicated, the tax reform should limit or reduce the incentive for households to go into debt and therefore ease the task of monetary policy over time. The staff had no additional information on the tax reform negotiations that were going on at the moment between the Government and the opposition parties.

As to the likely outturn of the wage negotiations, the staff representative acknowledged, most of the staff's information was drawn from newspapers. Reportedly, the unions' claims were on the order of 6 percent, while the employers were willing to offer 3 percent. Those figures referred to the settlements, to which would have to be added the usual wage drift of some 2.5 percent. Consequently, the outturn, although uncertain, was likely to exceed the official assumption of a 3.5 percent to 4 percent increase in actual earnings in 1985. Certainly, additional wage restraint would be required to reduce unemployment in a sustained way.

Whether the setback on the external side was temporary, as the authorities believed, depended on the relative strength of domestic demand, the staff representative from the European Department commented. If the relative strength of domestic demand were reversed, as had been projected in the staff's medium-term scenario, that setback might well prove to be temporary; an improvement in competitiveness would of course also be helpful.

Mr. Fugmann, commenting on his authorities' concern about Denmark's balance of payments prospects, remarked that a major objective of the Government had been to revitalize the private sector in order to enable it to solve the balance of payments problem. Therefore, the authorities had tightened fiscal policy and stabilized employment in the public sector; the strong expansion in employment in 1984 had taken place largely in the private sector. As to price developments, in addition to external factors, the 6 percent inflation rate in 1984--after a marked reduction from 1982 to 1983--had probably been attributable to increased profit taking, which had been necessary in order to shift income distribution. In sum, developments on the external front had not reflected a greater priority given to domestic objectives, but rather the necessary price in the short term for achieving the external objective through the private sector in the medium term.

Concerning possible policy shifts in 1985, particularly on the fiscal side, Mr. Fugmann observed, the question was whether any policy action should occur before or after the wage settlements had been concluded. If a further fiscal tightening were necessary, it would probably occur before the summer because of the upcoming local elections in November. The Government was closely watching balance of payments developments, and any tightening of policies would probably take place sometime following the outcome of wage negotiations in April. During the past few months, however, there had been signs that private consumption as well as the growth of housing was slowing down, which would be positive factors. Tax reform was expected to provide increased room for maneuver in monetary policy, but the final shape of the reform was as yet unknown. Nevertheless, tax reform was important because it was seen as a precondition for the support party of the Government to agree to further expenditure cuts in 1986; if any fiscal tightening should occur in 1985, it would likely take place through indirect taxation.

The main differences arising in the wage negotiations were not merely the proposed percentage increases but also the issue of shortening the standard work week, Mr. Fugmann observed. If a shortened work week were agreed, much would depend on how it was implemented; it could be accomplished in a way that would enhance productivity, but it could also be done in a manner detrimental to wage developments. The major negative impact of an unfavorable wage outcome would be felt in 1986 rather than in 1985.

The use of a reserve requirement was one of several new monetary instruments under consideration, Mr. Fugmann remarked. However, there was no general difficulty in controlling liquidity in the financial sector, but rather--from time to time--in the nonbank sector.

He did not consider the structure of Danish exports to be very sensitive to low-cost competition, Mr. Fugmann explained, because, for the past 20 years, structural adjustment in Denmark had been effective. In particular, the textile industry was competitive and profitable. For that reason, his authorities had argued that the Multi-Fiber Agreement should be abolished as soon as possible: Denmark did not need it, and it did great harm to other countries. As for the impact of wage increases on Denmark's competitiveness, the medium-term forecast of the Ministry of Finance had assumed that, in order to cut unemployment while maintaining a higher rate of growth than abroad, competitiveness would have to increase by at least 2 percentage points each year.

On monetary policies, Mr. Fugmann remarked, differences of opinion remained between the staff and his authorities. The authorities had accepted that monetary policy had been accommodating in 1984. However, in the Danish experience, the main impact of monetary policy had been on developments on the capital account and in the housing sector. In that context, the exchange rate between the Danish krone and the deutsche mark within the EMS had been stable for quite some time. Moreover, in the past, domestic liquidity had ranged within a wide band--the exact limits of which were not known--without any clear impact on prices or on economic activity in general. The authorities had attempted to tighten monetary policy without strangling the economic recovery from the beginning. Therefore, there had been a reluctance to do much on the monetary policy side at an early stage, but measures had recently been taken and the various growth rates in the monetary aggregates had come down.

In concluding, Mr. Fugmann noted, an Executive Director had remarked upon the stubbornly high unemployment rate in Denmark. Although unemployment remained too high, one of the more positive economic developments in 1984 had been the achievement of an actual reduction in unemployment--something which had not taken place in most other European countries in 1984.

The Chairman made the following summing up:

> Executive Directors warmly commended the Danish authorities for the impressive achievements of 1983 and 1984. The recovery, centered in the private sector, had been strong; fiscal imbalances had been cut significantly, and the rate of cost and price inflation had fallen. Investment had surged, and employment had risen markedly. However, Directors noted that, despite strong export performance, the external current account deficit had widened considerably to the equivalent of 3 percent of GDP in 1984, and inflation had remained above that in other industrial countries. Domestic demand pressures had contributed to this development.
>
> Directors noted that external debt had risen to a level that was high by the standards of industrial countries; they therefore strongly endorsed the authorities' aim to eliminate the external current account deficit over the next few years. They supported the strategy to achieve external adjustment through domestic cost restraint rather than through exchange rate depreciation, but they stressed that this required, in their view, greater domestic demand restraint than currently envisaged by the authorities.

Directors commended the authorities for the substantial reduction in fiscal imbalances that had been achieved. They welcomed the authorities' intention to reduce the deficit further over the next few years, and to eliminate it by the end of the decade. Nevertheless, most Directors indicated that an even faster pace of fiscal adjustment would be needed, in their view, to restrain domestic demand pressure, to achieve the objectives with regard to the external current account, and to reduce the pace of inflation to that of other competitors among the industrial countries. They added that the needed additional fiscal restraint in 1985 would depend in part on the outcome of the current wage negotiations and also on the role played by monetary policy. Directors believed that it was appropriate to base fiscal adjustment on expenditure restraint, and to reduce further the share of the very high noninterest expenditures in GDP. They also noted with interest the plans concerning tax reform aimed at improving incentives for private sector savings and investment.

Directors expressed concern about the rates of growth of money and credit experienced in the past two years, which had accommodated rising domestic demand pressures. They stressed the importance of moderating the growth of liquidity, and therefore welcomed efforts to reduce excess domestic lending by the banking system. A number of Directors supported the staff's view regarding the usefulness of an intermediate target for judging the impact of monetary policy, and they endorsed actions toward a more market-oriented monetary policy. However, Directors also recognized that the autonomy of monetary policy was clearly circumscribed by Denmark's commitment to fixed exchange rates relative to its EMS partners and to free capital movements, adding that the authorities should use any room for maneuver to keep financial policies adequately tight.

Directors noted that developments in 1985 would crucially depend on the outcome of the current wage negotiations. The outcome was far from clear, but it was apparent that the negotiations were difficult. Directors, while welcoming the extension for another two years of the suspension of automatic cost of living adjustments, observed that in an atmosphere of economic recovery and rising profitability, a more restrained stance of financial policies might have been helpful in improving the prospects for wage restraint. In any case, they stressed that a tightening of financial policies would be essential if wage settlements turned out to be higher than hoped for.

Directors welcomed Denmark's general adherence to the principles of free trade within the obligations of the European Communities. They commended the authorities for their development assistance record, which continued to go beyond the UN target.

It is recommended that the next Article IV consultation with Denmark be held on the standard 12-month cycle.

3. TRADE POLICY ISSUES AND DEVELOPMENTS

The Executive Directors considered a staff report on trade policy issues and developments, together with supplementary papers containing background material and a statistical annex (SM/85/60, 2/19/85; Sup. 1, 2/25/85; and Sup. 2, 2/25/85).

Mr. F. Fischer, Executive Secretary, Development Committee, and Mr. C. Michalopoulos, Director, Economic Policy Analysis and Coordination for the World Bank, were also present.

The Director of the Exchange and Trade Relations Department informed Executive Directors that he had recently been in contact with Mr. Dunkel, Director-General of the GATT, who welcomed the possibility afforded by the April meetings of the Interim and Development Committees to discuss trade issues; he was looking forward to introducing the session in the Development Committee. Mr. Dunkel had felt that it was valuable to have the finance ministers, and other ministers present, be fully informed on those issues, and he had conveyed the hope that the discussions would be a constructive force in encouraging pressures for open multilateral trade policies that the GATT was eager to promote.

One of the most important, and welcome, developments since the staff papers had been prepared was the U.S. action not to seek renewal of the voluntary restraints on exports of automobiles by Japan, the Director noted. On the other hand, the renewed U.S. congressional interest in an import surcharge was a matter of concern to the U.S. Administration and the Fund staff.

Finally, the Director of the Exchange and Trade Relations Department remarked, a number of small factual points had been received from Executive Directors. The staff would be taking them into account in correcting the background material in its report.

Mr. Kafka stated that instead of attempting to answer the questions posed at the end of the staff paper, he would comment on Part IV, which dealt with the role of the Fund. That seemed appropriate, since the proper forum for trade matters was the GATT, although there could certainly be no objection to the Fund's bringing its influence to bear on trade matters, provided--and he wished to stress that proviso--that it was able to do so in an evenhanded manner.

Concerning staff suggestions for improving Fund surveillance in connection with trade policy coverage in the context of Article IV consultations, Mr. Kafka noted, the fact remained that surveillance--which was not buttressed by sanctions--was a weak instrument. Therefore, it was not surprising that the staff's suggestions were not far-reaching. Moreover, in his view, if periodic seminars were to be organized in the trade field, they should be organized by the GATT rather than by the Fund; the GATT could of course invite the Fund and the World Bank to participate. He had no objection to the staff's assembling quantified estimates of the impact of trade policies for use in Article IV consultations, but, judging from the information contained in the staff papers before the Board, that endeavor appeared to be somewhat barren. Additional information was always helpful; member governments were well served by the GATT in being kept informed on trade developments. The Fund staff could request the GATT to make its information available on a timely basis, and the staff could then report to the Executive Board, with due regard to the respective functions of the GATT and the Fund.

The trade policy content of Fund programs was a delicate issue, Mr. Kafka remarked. Since surveillance had, in practice, no sanctions behind it, while Fund programs did, the more trade liberalization content was introduced into Fund programs, the more the Fund's impact on trade liberalization became asymmetrical between countries with and those without Fund programs. Certainly, the danger of asymmetry seemed to counsel discretion in using Fund programs to encourage trade liberalization.

Finally, regarding collaboration betweem the Fund and the GATT, Mr. Kafka welcomed the staff's suggestion that, when the Fund was aware that a consulting country was facing significant problems of market access abroad, the Fund statement in support of that country's case before the GATT's Committee on Balance of Payments Restrictions include Fund support for trade liberalization.

Mr. Zhang remarked that recent developments in trade policy were cause for concern. Despite concerted efforts at trade liberalization, protectionism had continued to grow at an accelerated rate; not only had existing trade barriers been intensified, but new ones had also been imposed on more sectors. Unfortunately, the sudden blossoming of a variety of trade restrictions in the late 1970s had not represented a temporary relapse from the general trend toward freer trade that had begun in the early postwar years, but rather a reversal of that trend: the international community had not been facing a recrudescence of incidental protectionist measures at a time of recession, but a syndrome indicating the beginning of the breakdown of the postwar international trading system.

Despite the conclusion of the Tokyo Round of multilateral trade negotiations to reduce tariffs, Mr. Zhang continued, no remarkable advance toward trade liberalization had occurred, except perhaps in specific areas of particular interest to selected countries. Nearly all the discriminatory restrictions against the exports of developing countries had been left intact, and no attempt had been made to terminate or reduce so-called voluntary export restraints.

An even more damaging development following the Tokyo Round had been the disregard by some major industrial countries of the rule of most-favored-nation (MFN) treatment in the implementation of multilateral trade negotiation (MTN) agreements, Mr. Zhang added. Those countries had chosen to withhold benefits accorded by MTN codes from countries that had happened to be unable or unwilling to accept those code obligations.

Moreover, some major industrial nations had an extremely high propensity to practice protectionism. Despite having accepted the liberal trade rules embodied in the GATT, they had suspended or ignored them wherever they could do so with impunity--for example, in their trade with countries having little or no bargaining power. Other industrial countries--even those with a long tradition of liberalism--had succumbed of late to the expediency of sheltering their industries from foreign competition. Those countries made use, on the one hand, of elaborate and ostensibly fair systems of antidumping and countervailing duties toward all "unfair competition," which implied immunity for competitors that practiced no dumping and enjoyed no subsidies. On the other hand, they also resorted extensively to escape-clause action, such as voluntary export restraints, where there could be no question of unfair competition. Such practices amounted to the replacement of a regime of fixed, measurable trade protection through customs tariffs by a regime of contingent protection through unpredictable discretionary action.

Another recent development had been the growing clamor in certain countries for "reciprocity" or "retaliation" against those countries that did not grant them market access "substantially equivalent" to their own, Mr. Zhang went on. Such "aggressive reciprocity" involved the violation of the principle of unconditional MFN treatment, which had been the basis of the trade policies of those same countries over the past 60 years.

The main question before the Board, Mr. Zhang considered, was whether a new round of multilateral trade negotiations should be undertaken. The decisions reached at the Tokyo Round had not yet been fully implemented, and, further, new protectionist measures had been introduced by the developed countries during the recession. Moreover, the answer would depend on the assumptions and approach to be adopted for a new round. For negotiations to be worthwhile, there must be a general, positive, ungrudging acceptance of the principle that trade patterns should be basically determined by comparative costs, subject as appropriate in a world of vastly uneven distribution of resources to considerations relating to the needs of economic development. With such genuine recognition of the value of international exchange, the reduction and removal of trade barriers in developed countries would become a natural desideratum. Such safeguard measures as might still be needed on occasion would automatically be nondiscriminatory and of short duration, and any necessary defensive action against "unfair competition" would surely be limited in scope as well as in duration.

Renewed respect for the basic economic principles of division of labor, Mr. Zhang noted, would reduce internal structural rigidities in the developed economies and facilitate the allocation of productive resources among domestic industrial sectors in response to changes in the pattern of trade. Without such a change in basic attitudes by the developing countries, trade negotiations would continue to aim at exchanging tariff and nontariff "concessions" and would be a futile exercise.

The trade barriers maintained by developing countries would eventually disappear along with all other trade barriers in an environment of liberal international trading, Mr. Zhang considered. Most of those restrictions were being maintained for legitimate purposes sanctioned by the GATT, which was supposed to embody balanced entitlements and obligations. The use and maintenance of such restrictions was governed by clearly defined criteria and precise procedural rules involving, among other things, recourse to the judgment of the Fund's Executive Board. It would therefore appear to undermine the Fund's authority to suggest that they should be placed on the table for negotiation. It might have been a mistake on the part of the GATT to abridge its proper procedures for periodic consultations on such restrictions with developing countries, and it might also have been an oversight on the part of the Fund to acquiesce in that abridgment. He considered the staff's proposal for a more effective linking of the Fund's Article IV consultations with those exercises in the GATT to be both commendable and timely.

Developing countries facing balance of payments difficulties and maintaining import restrictions on that account were required to relax their restrictions as and when their balance of payments improved, Mr. Zhang observed. In general, they were not allowed to restrict imports under an adjustment program. The only way they could enlarge their import capability therefore was to increase their export earnings, which obviously could not be achieved if developed countries indulged in protectionist measures and restricted imports from those countries. His own country, for example, had recently decided to open its economy to foreign participation and to enter the world market on a permanent, multilateral basis. The continued sustainability of such a policy would depend on the existence of an open world economy; it could not be sustained if developed countries persisted in obstructing China's attempt to resume active participation in the institution of world trade policy or in denying it equitable access to their markets, as in the case of textiles and certain other products.

Regarding the content of any future trade negotiations, Mr. Zhang noted, it was evidently premature--if not inappropriate--to extend preparatory consideration to such new areas as services and high technology. Those were highly complex problems having long-term, broad implications. The present disposition to undertake careful studies before talking about any negotiations was a wise one.

Addressing the specific questions raised by the staff, Mr. Zhang remarked that accelerated trade liberalization was of course desirable if it was feasible and purposeful. It would be purposeful when there was a genuine, true appreciation of the value of international trade on the basis of comparative advantage. A strong and effective international body, such as the GATT, unencumbered by undesirable loopholes and aberrations, would be of great value in encouraging or enforcing the restoration of multilateralism and the eschewing of bilateral practices. It would be illusory to expect multilateral trade negotiations to act as a brake on protectionist actions; the outbreak of protectionist measures even before the close of the Tokyo Round made that evident. In his view, liberalization of trade with developing countries was at present, as it had always been, the most urgent and desirable action that developed countries could take, and they should undertake such liberalization without hesitation as it was in their own interest as well as in the interest of general world prosperity and peace. Trade liberalization by developing countries should by all means be encouraged, but the key was for developed countries to set the example and to strive to augment the export earnings of their trading partners.

In concluding, Mr. Zhang expressed his full appreciation for the staff's valuable observation that a general lack of appreciation of the costs of protection and the ignoring of economic arguments for liberal trade had contributed to the global problem of balance of payments adjustment and had impeded the growth prospects of developing countries.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/85/42 (3/15/85) and EBM/85/43 (3/18/85).

4. USE OF FUND ARCHIVES

In accordance with the arrangements for clearance of the book by Mr. Joaquín Muns entitled History of the Relations Between Spain and the International Monetary Fund, 1958-1982 (EBD/85/33, 1/25/85), to be published by the Bank of Spain, the Executive Board approves the release of the history as set forth in EBD/85/33, Supplement 1 (3/4/85).

Adopted March 15, 1985

5. APPROVAL OF MINUTES

The minutes of Executive Board meetings 84/101 and 84/102 are approved. (EBD/85/71, 3/11/85)

Adopted March 15, 1985

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/85/64 (3/14/85) is approved.

APPROVED: January 7, 1986

LEO VAN HOUTVEN
Secretary