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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/109

3:00 p.m., July 17, 1985

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	N. Toé, Temporary
	E. L. Walker, Temporary
	H. G. Schneider
	G. Nguyen, Temporary
	A. Mustafa, Temporary
	M. Sugita
G. Grosche	
J. E. Ismael	
	L. Leonard
	H. A. Arias
H. Lundstrom	
	A. Abdallah
	M. A. Weitz, Temporary
	E. M. Taha, Temporary
	J. de la Herrán, Temporary
J. J. Polak	
C. R. Rye	
	A. V. Romuáldez
	H. Alaoui-Abdallaoui, Temporary
	A. Vasudevan, Temporary
	R. Fox, Temporary
	N. Coumbis
	Yang W.-M., Temporary

L. Van Houtven, Secretary
S. J. Fennell, Assistant

Also Present

European Department: L. A. Whittome, Counsellor and Director; O. J. Evans, W. L. Hemphill, A. Knöbl, S. Mitra, H. Ungerer. Exchange and Trade Relations Department: J. T. Boorman. Legal Department: J. K. Oh. Personal Assistant to the Managing Director: S. P. Collins. Assistants to Executive Directors: W.-R. Bengs, G. D. Hodgson, A. K. Juusela, W. K. Parmena, M. Sarenac, L. Tornetta.

1. FINLAND - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Finland (SM/85/178, 6/24/85). They also had before them a report on recent economic developments in Finland (SM/85/189, 7/2/85; and Cor. 1, 7/15/85).

Mr. Lundstrom made the following statement:

During the last few years, Finland has experienced steady economic growth and has been able to mitigate the effects of the international recession. In 1980-84, real GDP growth averaged 3.2 percent, exceeding that of European members of the Organization for Economic Cooperation and Development (OECD) by 2 percentage points. Growth has also been relatively stable compared to the traditional sharpness of cyclical variations.

Recent information indicates that balanced economic development will continue in 1985. Total production is expected to grow by 3.5 percent in 1985, with exports and private demand being the driving forces. An extensive investment survey recently undertaken by the Bank of Finland concludes that industrial investment is picking up and the 1985 growth rate could even exceed earlier estimates. In addition to underpinning the growth estimate for total production, that development also suggests that the relatively high real interest rate has not been detrimental to business investments.

Developments on the current account, which moved into balance in 1984, have remained rather balanced in recent months. Also, capital movements stabilized as the strong influx of short-term capital gradually ceased during the early months of the year. However, capital inflows through the Helsinki Stock Exchange picked up rapidly during the spring. In order to keep the situation under control, the sale abroad of bonds and debentures quoted on the Exchange was forbidden in June.

Employment has developed satisfactorily, especially compared with many other countries. While over the past five years employment in Europe has declined, employment in Finland has increased by 4 percent. However, as the supply of labor has continued to grow, unemployment is forecast to remain at 6 percent in 1985, a figure which the authorities are firmly committed to reducing. It is recognized that that is a protracted enterprise, which requires increased competitiveness, a strengthening of the production base, and a reduction of rigidities.

In the circumstances, the major economic concern of the Finnish authorities is to secure the continuation of the gradual reduction in inflation. The reduction so far has been insufficient to bring the Finnish inflation rate down to that of its main trading partners. As the rate of increase in consumer prices during the first five months has exceeded forecasts, the Government's ceiling of a 5 percent rise during 1985 is likely to be slightly exceeded.

The international cost competitiveness of Finnish industry has gradually deteriorated since 1982, although the figure for the exact amount of erosion depends on definitions and methods used. However, the concurrent strength of profitability has supported investment activity and contributed to improving the adaptability of Finnish industry, thereby sharpening its overall competitive edge in international markets.

In order to reduce inflation, maintain competitiveness and balance the budget, fiscal policy was tightened considerably in 1984. The tight fiscal stance is being continued in 1985, and the Government has taken further measures to lower inflation and support business activity. These measures include the abolition of employers' temporary child allowance contributions, and reductions in electricity and automobile taxation. In addition, measures designed to increase competition and to reduce price linkages between sectors are under consideration. The authorities have also aimed at advancing productive investments by releasing voluntary countercyclical deposits that corporations have made in the investment reserve fund.

The Finnish authorities' medium-term objective is to limit the relative size of the public sector by reducing the annual rise in government spending to 2 percent in volume terms. Within that target, central government transfer payments would grow by only 1 percent, a considerable reduction from previous developments. That goal should be attainable as no new social policy reforms are envisaged.

The stringency of monetary policy has been slightly relaxed since early 1984. As the goal of reducing inflation is accorded the highest priority, domestic short-term interest rates are still high by international standards. In a phase of rapid transition of the financial system, it is, however, difficult to assess the policy stance by commonly used aggregates, or to foresee the effects of enacted measures. The Finnish authorities share the view of the Fund staff regarding the necessity to avoid a rapid easing of monetary policy at the present juncture. At the same time, it is also felt that there is a continuing need to develop new instruments and practices to implement policies in the new environment.

Mr. Schneider commented that the Finnish authorities deserved to be commended for their successful management of the economy. Steady economic growth and a sound balance of payments position had been achieved.

Inflationary pressures arising from the large stimulus of export demand had been successfully countered by monetary and fiscal policies. The liquidity effects of the larger than expected capital inflows in late 1983, owing to the tightening of monetary policy, had been neutralized. Real GDP had continued to grow by 3 percent in 1984; the rate of unemployment had been maintained at about 6 percent for the third consecutive year, despite the growing labor force; and the consumer price index had dropped from 8.5 percent in 1983 to 6 percent in 1984.

The prospects for maintaining a balanced growth path in the medium term were good provided that the authorities continued to pursue the present policy orientation, Mr. Schneider considered. Their determination to maintain and strengthen the international cost competitiveness of the industrial sector through domestic cost restraint rather than through a depreciation of the currency was particularly reassuring. Mr. Lundstrom had affirmed in his introductory statement that a gradual reduction in inflation was one of the major priorities of the authorities. The tightening of fiscal policy in the past two years had created some room for the pursuit of a more expansionary policy in case of a future downturn in the economy.

Public sector expenditures were expected to rise from 37 percent of GDP in 1981 to 40 percent of GDP in 1985, a development that might hamper productive forces in the economy over time, Mr. Schneider noted. He therefore welcomed the authorities' intention to emphasize expenditure restraint rather than revenue-raising measures. Could the staff or Mr. Lundstrom indicate when the authorities expected to reduce the annual rise in government spending to 2 percent a year? What concrete measures were being considered to attain that objective?

He encouraged the authorities to continue with the gradual decontrol of interest rates and the integration of the regulated and unregulated financial markets, Mr. Schneider said. The staff's presentation of the merits and difficulties of financial deregulation was welcome. The authorities were faced with the difficult task of pursuing a relatively tight monetary policy in an effort to reduce domestic inflation, while trying to isolate the exchange rate from the effects of capital inflows arising from that policy. The recent upsurge of capital inflows through the Helsinki Stock Exchange indicated that the balance between those two objectives had not yet been achieved. The authorities' recourse to a ban on the sale abroad of bonds and debentures quoted on the Exchange was regrettable. What was the staff's view on how that policy conflict could be dealt with, given that the competitive position of the export industry did not seem to justify an appreciation of the markka? Finally, he agreed with the proposed decision and the suggestion to hold the next Article IV consultation with Finland on an 18-month cycle.

Mrs. Walker observed that the authorities and the Executive Board had been in substantial agreement on three major policy issues: the need for tighter fiscal policy; the need for continued reform in the financial sector, in particular, by allowing interest rates to play a greater role in credit allocation; and the importance of holding the line on public sector wage negotiations in an effort to achieve overall price stability. Finland's economic performance in the past several years had been relatively good, especially with respect to real economic growth and the budget and balance of payments positions. Economic performance had been positively affected by supply-side incentives, which had been introduced earlier than in other countries and which were evidenced by the growth of investment of 4 percent in 1985. While progress had been made on the inflation front, the rate of inflation remained at 6 percent, a higher rate than those of Finland's trading partners. The improvement in the fiscal position might have been more appropriately achieved through expenditure reduction than through tax increases, which might conflict with other supply-side measures taken in the past. The tax burden would remain high in Finland, although the authorities had stated that the tax increases in 1984 would expire by the end of 1985. What measures were the authorities considering to reduce government spending? The difficulties in coordinating fiscal policy at the central and local government levels was cause for concern, particularly as over 60 percent of public spending on goods and services was carried out at the local level. She urged the authorities to improve control over local government spending. Wages in Finland should be brought more in line with the country's trading partners in order to maintain its competitiveness and to curb inflation.

The measures taken to move toward a more market-oriented financial system were welcome, particularly the decision to allow banks to pass part of the cost of unregulated rate funds through to regulated lending rates, the development of the call money rate and its use by the central bank as an instrument in allocating credit, and the recent development of a secondary market in certificates of deposit and the introduction of treasury bills, Mrs. Walker remarked. Could the staff or Mr. Lundstrom indicate the timetable for fully deregulating the financial markets? As the financial system was increasingly integrated in the world financial markets, Finland would have to develop new instruments and practices to implement monetary policy in the new environment.

The authorities should not change their present stance of monetary policy, given the recent trends in capital flows and the exchange rate, Mrs. Walker commented. In conclusion, the authorities' achievements were commendable; the fiscal and current accounts were virtually in balance, real growth was strong, and the economic prospects were generally favorable.

Mr. Leonard remarked that Finland's performance in 1984 had been good, with a rate of growth of 3 percent, a moderation in the rate of inflation to 6 percent, and general balance of payments stability. The restrained fiscal and monetary policies had prevented the economy from overheating, and the authorities' discouragement of excessive wage settlements had helped to avoid an erosion of competitiveness. Those measures were consistent with the views expressed by Executive Directors at the Board's discussion of the previous Article IV consultation with Finland (EBM/84/35, 3/2/84), representing a solid example of the effectiveness of the Fund's surveillance role.

The generally positive economic trend was expected to continue into 1985, Mr. Leonard noted. Mr. Lundstrom had indicated that a projected rate of growth of 3.5 percent might be on the conservative side; the actual outturn might allow Finland the luxury of reducing unemployment below 6 percent.

Given the authorities' intention to reduce inflation further to the level of the country's major trading partners and the expectation of a strong growth stimulus from private investment, the planned shift to a more restrictive fiscal policy in 1985 was appropriate, Mr. Leonard considered. A reduction in the fiscal deficit would give the authorities more room for maneuver in the medium term. However, it was disappointing that the fiscal tightening in 1985 was being accomplished through increased taxation rather than expenditure reduction. The lack of coordination of fiscal policy between central and local governments was also of concern, as adjustment at the national level could easily be undermined or negated by local action in the opposite direction. Could the staff or Mr. Lundstrom comment on whether measures, other than stronger voluntary guidelines, were being considered?

The greater than expected impact on the balance of payments of the tightening of monetary policy in 1984 through a sharp increase in the call money rate suggested that the reform of financial and monetary institutions could, if continued, make monetary policy a more powerful macroeconomic instrument than in the past, Mr. Leonard stated. More rapid integration of the regulated and unregulated markets would be advisable both to lower real interest rates and to broaden the direct impact of monetary policy. As the movement of monetary aggregates was difficult to interpret, at present, the call money rate should remain the principal policy instrument. The authorities should exercise caution in any further easing of monetary policy for the time being as it might result in undesired capital outflows.

Since the 1982 devaluation of the markka, Finland had relied upon a fixed exchange rate regime, which was regulated by monetary policy and was dependent on wage increases that did not impair its international competitiveness, Mr. Leonard noted. That policy had been successful thus far and would remain so as long as firm domestic policies remained in place. However, the pursuit of such a policy placed great emphasis on the wage bargaining process and made it all the more necessary that there should be convergence between wage settlements in Finland and those in its trading partners. Had the authorities' offer to lower marginal tax rates in exchange for wage moderation been followed up?

Finland's external indebtedness was not cause for concern provided that the present policy stance was maintained, Mr. Leonard remarked. The authorities' medium-term scenario was more optimistic than that of the staff and was dependent on maintaining, and perhaps even improving, the country's competitiveness and, therefore, on wage moderation.

Mr. de la Herrân remarked that economic growth in Finland had been compatible with internal and external equilibrium. The rate of inflation, while not as low as some of Finland's trading partners, remained moderate. The authorities should be commended for their determined pursuit of restrictive policies. In the fiscal area, a shift toward expenditure control rather than increased taxation would be desirable. The authorities should direct particular attention to local government expenditure, which should be coordinated within general policy guidelines. To what extent did the reduction in the electricity tax in 1985 represent an instrument of fiscal policy, or did that measure represent an incentive to promote the use of electricity vis-à-vis other energy sources?

A reduction in the rate of inflation must be of the highest priority, Mr. de la Herrân stated. However, it was unclear whether tighter monetary and fiscal policy measures would allow Finland to reach the projected level of gross fixed investment of 4.5 percent in 1985. The liberal trade policy pursued by the authorities was commendable, and he welcomed their generous provision of official development assistance (ODA).

Mr. Taha stated that he agreed with the staff appraisal. The Finnish economy had performed well; real GDP growth had been higher than in many industrial countries, and the external balance had moved from deficit into surplus. A continuation of those favorable trends was expected in the short term. However, attention should be focused on a number of policy areas. In particular, domestic spending should be reduced in order to preserve external competitiveness and maintain the growth of output and employment. Progress would depend critically on striking the right balance between fiscal, monetary, incomes, and exchange rate policies.

The current tight fiscal stance should be maintained and, if necessary, strengthened, Mr. Taha considered. The central and local budget operations should be coordinated more closely and spending by local agencies should be controlled. Fiscal restraint should be supported by a stringent monetary policy so as to dampen inflation. The authorities' efforts to improve the effectiveness of monetary policy and instruments through various institutional reforms were welcome and should be continued in order to reduce the structural rigidities in the financial markets. Moderate wage settlements that were consistent with productivity gains would help to lower the rate of inflation and maintain Finland's international competitiveness. Finally, Finland's adherence to the principles of free trade was commendable.

Mr. Grosche stated that he agreed with the staff appraisal. Finland's economic performance in 1984 had been satisfactory in many respects, largely owing to the authorities' pursuit of appropriate policies. However, some dark spots remained in the economy. The rate of inflation, although declining slightly in 1984, was still higher in Finland than abroad, reducing the country's international competitiveness. The marked real appreciation of the exchange rate might adversely affect Finland's exports with some time lag, even though the country had gained shares in export markets in 1984.

The tighter fiscal position, while appropriate, had been brought about mainly through revenue-raising measures rather than through expenditure restraint, Mr. Grosche observed. In particular, transfer payments had risen strongly, and slippages had occurred with regard to the medium-term objectives. Furthermore, the expenditure policy of the local authorities had been out of line with the overall fiscal stance of the Government. The authorities were well aware of those developments and were determined to keep domestic demand under control in order to reduce inflation further. The envisaged stance of fiscal policy seemed appropriate, particularly the intended shift away from increasing revenues toward expenditure restraint. It was encouraging to learn from Mr. Lundstrom's opening statement that government transfer payments would be allowed to grow by only 1 percent in volume terms in 1985, compared with 2 percent for total expenditures. Some efforts were being made to increase financial discipline at the local level, although more could be done in that area.

A cautious monetary stance remained appropriate, and a further easing should be contemplated only if further progress were made in containing costs and inflation, Mr. Grosche considered. Efforts to establish a more market-oriented financial system should facilitate the conduct of monetary policy.

A further erosion of Finland's international competitiveness should be avoided, preferably through firm domestic policies aimed at cost restraint rather than through a depreciation of the exchange rate, Mr. Grosche remarked. Finally, he agreed with the recommendation that the next Article IV consultation with Finland should be held on an 18-month cycle.

Mr. Polak noted that most of the concern expressed by Executive Directors at the discussion of the 1983 Article IV consultation with Finland had been fully reflected in the authorities' policy decisions. The financial policy stance had been tightened, positive interest rates had been introduced through the pursuit of a tight monetary policy, and wage settlements in early 1984 had been relatively moderate. The success of the authorities' policy approach was enviable.

While competitiveness had been reduced somewhat, Finnish industry remained highly profitable and Finland's competitive position was still reasonably strong, Mr. Polak observed. The aim to maintain competitiveness through domestic cost restraint by a firm anti-inflationary policy rather than by a devaluation was welcome. However, as a consequence, monetary policy would have to be determined largely by balance of payments considerations. The staff had pointed out that a fixed-rate approach would also preclude using a more flexible exchange rate policy to ward off large capital inflows. Why, then, had the staff recommended the adoption of a more flexible exchange rate policy? The authorities could reduce the conflict between exchange rate policy and monetary policy by integrating the regulated and unregulated financial markets so that if there were a need for tighter monetary policy, the call money rate would not increase as sharply as it had in 1984. Finally, he agreed with the staff appraisal.

Mr. Rye suggested that Finland should perhaps be put on a 24-month cycle for Article IV consultations. The Finnish economy did not have a major impact on other economies, even at the regional level, and its economic performance record was enviable.

The staff representative from the European Department remarked that the authorities' medium-term fiscal objective was to maintain a relatively low tax ratio; the government sector in Finland was small compared with that of other European countries. In the medium term, the authorities intended to focus on expenditure restraint, although the time frame and precise measures to be introduced had not yet been determined. Action would undoubtedly be taken to restrain transfer payments to the local authorities by increasing cooperation between the local and central governments in order to improve the fiscal performance of the local authorities and to bring fiscal policy as a whole more in line with the authorities' medium-term objectives.

Wage agreements for 1984 and 1985 had been relatively favorable, although perhaps not favorable enough from the viewpoint of cost competitiveness, the staff representative noted. The authorities considered that Finland's competitiveness remained strong, given the high quality of its products and the high technological nature of its industries. However, the staff felt that the effects of a deterioration in cost competitiveness might be experienced after some delay. Future wage agreements should be in line with the inflation objectives.

The authorities were of the view that a realistic energy pricing policy should be pursued in order to reduce energy consumption, the staff representative explained. However, they had increased electricity prices temporarily in 1985 to exert a short-term restraining impact on the economy.

The Finnish authorities had successfully pursued a fixed exchange rate policy together with a tight monetary policy by using forward intervention in the exchange market, a course of action that diminished the excess liquidity in the country, making it possible to maintain high interest rates, the staff representative said. The authorities intended to deal with problems as they arose rather than to establish an orthodox policy approach in advance. The level of the exchange rate was broadly appropriate. In suggesting that the authorities should pursue a somewhat more flexible exchange rate policy, the staff had merely been proposing that they should create more uncertainty in the way exchange rate policy was implemented in order to make it more difficult for investors to find a high interest rate haven in Finland. The authorities could consider widening the band of fluctuation or making discretionary changes in the exchange rate, thereby creating an element of risk for those individuals wishing to invest their funds in Finland. Alternatively, the authorities could consider not announcing the band of fluctuation at all.

Maintaining the current level of interest rates would represent a further tightening of policy, assuming that the rate of inflation continued to fall, the staff representative from the European Department commented. The authorities did not have a precise timetable for the transition to a fully integrated monetary system, but were determined to integrate the regulated and unregulated financial markets gradually in order to maintain financial balance.

The staff representative from the Exchange and Trade Relations Department stated that the general procedures for surveillance outlined in the Managing Director's summing up of the conclusion of the review of surveillance on March 28, 1983 (EBM/83/55) determined that the 25 countries with the largest quota would be on an annual cycle of Article IV consultations. An 18-month cycle had been recommended for Finland because of the size of its quota and the importance of its economy for neighboring countries and its trading partners. Luxembourg was the only country on a 24-month cycle to date.

The Director of the European Department remarked that Finland, while a member of the OECD, was not a member of the more tightly knit communities in Europe. The authorities appreciated the opportunity to discuss their economic policy with Fund staff at least every 18 months. If the Article IV consultations with Finland were held on a 24-month cycle, the staff would find it difficult to remain in touch with economic developments in the country. Furthermore, it would be more difficult to ensure continuity between missions, as staff members on the mission and officials in Finland would change. In addition, the projections used in the report on the world economic outlook would be more reliable if the Article IV consultation with Finland were held every 18 months. In conclusion, it would be of little benefit to the staff if the cycle for Finland were extended from 18 months to 24 months.

Mr. Lundstrom stated that he was less concerned than some Directors about cost and price developments in Finland, in view of corresponding developments in Finland's neighboring country to the west. The rise in real hourly compensation in 1982 and 1983 had been less than the economy-wide productivity gains, and the two-year comprehensive income settlement for 1984 and 1985 had been moderate. The average increase in consumer prices had declined from 9.5 percent in 1982 to 8.5 percent in 1983 and 7 percent in 1984. The rate of inflation was targeted to be 6 percent in 1985, or 5 percent on a December-December basis, a figure that was not expected to be more than marginally exceeded, if at all. It was difficult to determine how the external competitiveness of the Finnish economy had been affected by developments, because various indicators pointed in different directions. However, it was clear, on the one hand, that the competitive gains from the 1982 devaluations had largely been eroded mainly owing to a higher inflation rate in Finland than in most of its competitor countries. On the other hand, Finland had made considerable gains in market shares, particularly in 1984, and its relative industrial profitability seemed to be unaffected by deteriorating competitiveness. It was cause for concern that price levels in Finland had increased somewhat more rapidly than in many of its trading partners. The full impact of that increase might not become apparent until demand for major

Finnish export products declined. The authorities were well aware of that problem and were determined to pursue their fight against inflation.

Cost and price developments would greatly depend on the outcome of the wage negotiations in early 1986, Mr. Lundstrom pointed out. Indications were that the Government might be prepared to contribute, by means of tax concessions, to a possible comprehensive incomes agreement between the social partners. In any event, the authorities recognized that restrictive financial policies were a prerequisite for a moderate incomes agreement.

Transfer payments had increased and public spending represented a large share in the budget, Mr. Lundstrom agreed. Furthermore, that share had been rising, owing to a comprehensive reform of both the transfer system between the Central Government and local governments and the pension system. However, the pension reform had inflated both sides of the budget, as pensions had become subject to taxation. No particular increases were expected after those reforms had been implemented, and the share of transfer payments was projected to begin decelerating gradually. It was clear from Table 1 of the staff report (SM/85/189) that government spending in general in Finland was not high; the United States was the only country with lower general government spending as a percentage of GDP.

Investment activity in 1983 and 1984 had been more favorable than forecast, Mr. Lundstrom indicated. Investment growth in 1983 had been 4.8 percent compared with the earlier estimate of 2.5 percent, and, in 1984, it had been minus 2 percent rather than the estimated minus 3 percent. The decline in investments in 1984 might have been a result of measures introduced to dampen overheating in the economy, including higher interest rates.

Directors had inquired about the recent ban on the selling abroad of bonds and debentures quoted on the Helsinki Stock Exchange, Mr. Lundstrom recalled. The Bank of Finland traditionally regulated capital inflows by the granting of permits. However, bonds and debentures denominated in the markka had not been subject to such a regulation. But, in spring 1984 sales abroad of debentures had increased to such an extent that it was considered that the consequent inflow of liquidity would jeopardize the authorities' stance of monetary policy. The ban was temporary and would remain in effect until further notice by the Bank of Finland. Demand for debentures had probably accelerated because of the lack of company shares marketable abroad. The Finnish legislation set a ceiling on the proportion of shares in Finnish companies available to foreign investors. The supply of such "free" shares had been more or less depleted, and bonds and debentures might have been regarded as an alternative.

The authorities had not yet decided on new instruments and policies to be used within the framework of monetary policy, Mr. Lundstrom remarked. However, the recent introduction of certificates of deposits and transferable bank borrowing by the Government--treasury bills--might indicate the direction in which the authorities were likely to go.

As to the appropriate cycle for Article IV consultations, Finland was a good example of a country that was neither a problem country nor sufficiently important to affect the international monetary situation significantly, Mr. Lundstrom observed. He considered that the authorities would not object if Finland were put on a 24-month cycle, provided that the sort of problems to which the Director of the European Department had referred would be avoided. It was essential that the staff remained in close contact with developments in all member countries. Perhaps the Executive Board should consider putting some countries on a 24-month cycle, with a more extensive consultation being held every other year and a less ambitious surveillance procedure in the intervening year.

The Chairman made the following summing up:

Directors commended the authorities on the favorable economic performance of Finland in recent years. Economic growth had been distinctly higher than in partner countries. The external current account had moved into balance in 1984 and inflation had been reduced. Directors agreed that the good performance had been positively influenced by successful economic policies, which were set in a medium-term framework, and relied on a blend of supply side, demand management, and incomes policies.

The forecast GDP growth in 1985 of 3.5 percent, or perhaps even higher, was also encouraging, and it was noted that the external current account was expected to remain approximately in balance. Directors understood the authorities' desire to reduce unemployment. They nonetheless agreed that the reduction of inflation, at present a little above that in partner countries, should remain the prime target of policies.

Directors welcomed the fiscal tightening implemented in 1984, and the further tightening in the 1985 budget. However, Directors were concerned that the tightening had mostly reflected revenue measures rather than cuts in expenditures. Noting that general government expenditure had risen to the equivalent of some 40 percent of GDP, they urged in particular that the recent trends toward increases in transfer payments be reversed. Directors, therefore, welcomed the announced objective of the Finnish authorities to limit the size of the public sector by reducing the annual rise in total government spending to 2 percent in real terms and the rise in central government transfer payments to 1 percent over the medium term. Several Directors also noted the importance of achieving greater harmony between the fiscal approaches of the Central Government and the local authorities.

Directors commended the firm monetary policy pursued in 1984 but noted that this had produced strong upward pressure on the exchange rate. It was suggested that the recent easing had probably gone far enough, particularly as inflation remained above that abroad and as capital inflows had subsided. The simultaneous achievement of a reduction in inflation together with the avoidance of upward pressure on the exchange rate constituted a continuing challenge to monetary policymakers, Directors observed. Directors welcomed the progress made in establishing a more market-oriented financial system, though it was suggested by some Directors that efforts to integrate the regulated and unregulated financial sectors should be accelerated.

Directors observed that the 1986 wage round would be crucial for further reduction in the rate of inflation and, thus, for safeguarding competitiveness. They commended the authorities for their determination to maintain an adequate competitive position through cost restraint rather than depreciation of the exchange rate, and judged that continued implementation of firm financial policies would be vital in this respect, all the more so since Finland's international cost-competitiveness had somewhat weakened in recent years.

Directors commended the authorities on their development assistance record and for their commitment to increase the level of official development assistance to the UN target.

In the framework of Fund surveillance, Directors were gratified that the policies of the Finnish authorities were in line with the suggestions and recommendations formulated by the Executive Board on the occasion of the 1984 consultation.

It is expected that the next Article IV consultation with Finland will be held in approximately 18 months.

APPROVED: April 10, 1986

LEO VAN HOUTVEN
Secretary