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Minutes of Executive Board Meeting 85/123

3:00 p.m., August 7, 1985

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
A. Alfidja	
C. H. Dallara	M. K. Bush
	E. L. Walker, Temporary
	H. G. Schneider
B. de Maulde	S. de Forges
	M. B. Chatah, Temporary
H. Fujino	H. Kobayashi, Temporary
	K. Murakami, Temporary
	B. Goos
J. E. Ismael	Jaafar A.
R. K. Joyce	
	J. R. N. Almeida, Temporary
H. Lundstrom	H. Fugmann
E. I. M. Mtei	A. Abdallah
	M. A. Weitz, Temporary
	J. E. Suraisry
	G. Ortiz
	J. de Beaufort Wijnholds
C. R. Rye	A. V. Romuáldez
G. Salehkhou	
A. K. Sengupta	
	T. A. Clark
	D. J. Robinson, Temporary
S. Zecchini	N. Coumbis
	Yang W., Temporary

L. Van Houtven, Secretary
L. Collier, Assistant
R. S. Franklin, Assistant

Also Present

S. Hamed, Minister of Economy and Finance of Egypt; Aly Negm, Governor of the Central Bank of Egypt; A. H. Ali, Commercial Minister, Embassy of Egypt. IBRD: S. Moini, Europe, Middle East and North Africa Regional Office. Asian Department: M. B. Haque, M. Ishihara, B. J. Smith. European Department: P. B. de Fontenay, Deputy Director; O. J. Evans, P. L. Hedfors, M. Mentini, S. Mitra. Exchange and Trade Relations Department: M. Guitián, Deputy Director; G. Belanger, J. T. Boorman, Y. Boutros-Ghali. Fiscal Affairs Department: G. Blondal, C. A. Sisson. IMF Institute: L. Nielsson, Participant. Legal Department: S. A. Silard. Middle Eastern Department: A. S. Shaalan, Director; P. Chabrier, Deputy Director; K. Nashashibi, S. M. Thakur, A. Yahie, M. Zavadjil. Research Department: J. P. Horne. Advisors to Executive Directors: A. A. Agah, P. E. Archibong, D. Hammann, K. A. Hansen, H.-S. Lee, G. W. K. Pickering, E. M. Taha, A. Vasudevan. Assistants to Executive Directors: I. Angeloni, W.-R. Bengs, J. de la Herrán, A. K. Diaby, S. de Forges, R. Fox, O. Isleifsson, A. R. Ismael, M. Lundsager, R. Msadek, A. Mustafa, J. Reddy, J. E. Rodríguez, M. Sarenac, A. A. Scholten, L. A. Tornetta, B. D. White, A. Yasseri.

1. ARAB REPUBLIC OF EGYPT - 1985 ARTICLE IV CONSULTATION

The Executive Directors continued from the previous meeting (EBM/85/122, 8/7/85) their consideration of the staff report for the 1985 Article IV consultation with the Arab Republic of Egypt together with a proposed decision concluding the 1985 Article XIV consultation (SM/85/177, 6/24/85; and Sup. 1, 8/5/85). They also had before them a report on recent economic developments in Egypt (SM/85/198, 7/10/85).

Also present were Mr. Salah Hamed, Minister of Finance of Egypt; Mr. Aly Negm, Governor of the Central Bank of Egypt; and Mr. Abdel Halim Ali, Commercial Minister, Embassy of Egypt in Washington, D.C.

Mr. Hamed said that Egypt's economy had moved from complete rigidity in the 1960s to extreme openness in the 1970s, thus compounding the current problems. The authorities were undertaking fundamental structural changes; for example, producer prices had been increased in the past year by 20-30 percent. That action had brought about a diversion of agricultural production from traditional to other crops, although the area of cultivated land had remained unchanged at 6 million feddans. The area under cotton cultivation had increased from 900,000 feddans to 1.1 million feddans as a result of a 30 percent increase in prices; that devoted to clover, a cattle feed, had been reduced from 3 million feddans to 2 million, thereby freeing land that was at present planted with edible oil seed, lentils, and other food crops, thus encouraging food production and import substitution.

The authorities had implemented a wide range of consumer and public sector price increases, which had added LE 534 million to public sector revenue during the past year, Mr. Hamed reiterated. By following a pricing policy of covering costs plus a profit margin, the number of public sector companies operating at a loss had been reduced from 51 in 1983/84 to 4 in 1984/85. In the energy sector, electricity tariffs had been raised significantly, by 40 percent. Petroleum product prices had increased by 200-400 percent in one year. Those measures illustrated the aggressiveness of government policy to raise prices to international levels.

With regard to the privatization of investment, land reclamation by the private sector covered 2.3 million feddans, compared with 600,000 feddans at the inception of the program, Mr. Hamed continued. The population, notably workers in the Gulf area, was preparing to purchase the land and to undertake reclamation. Prices of vegetables and fruits were determined by the free market. In the services sector, the bus transportation system in Cairo was being transferred from the public sector to the private sector as of September 1, 1985. International prices would be a guideline for resource allocation in future.

The current five-year plan concentrated on the rehabilitation of industries to yield increased production so as to improve the supply of commodities in Egypt, replace imports, and promote exports, Mr. Hamed remarked. About 65 percent of investment would be for rehabilitation and 20-25 percent for infrastructure, which was needed to attract private investors to Egypt.

In the energy sector, the use of natural gas was being encouraged to replace imported propane gas, Mr. Hamed reported. Oil conservation was being promoted in several ways; in 1985, LE 75 million had been allocated in a program to conserve oil in various industries. The rapid increase in the price of oil would also reduce domestic consumption significantly, thus permitting increased exports.

Import substitution was being vigorously pursued, for instance, with respect to such items as cement, steel bars, and edible oil, Mr. Hamed noted. Four factories would add about 4 million tons of cement to the present level of production. Private sector industry had increased production, for example, of steel bars for construction. Almost 600,000 tons of edible oil would be produced from the area formerly planted with clover.

The measures he had described indicated that the authorities were attacking Egypt's structural weaknesses aggressively, Mr. Hamed remarked, and they would continue to do so at an accelerated pace in the future. The absorptive capacity of a country could be defined not only as the utilization of resources in economic terms but also as the ability of the people to shoulder the burden of that aggressive structural reform. If the burden was too heavy, it would cause instability. The authorities were undertaking an ambitious economic reform that took into consideration the income redistribution aspects as well as the impact on social and political stability in order to allow the country to attain the economic goals in a peaceful environment.

More flexibility had been introduced in fiscal policy, Mr. Hamed noted. On the expenditure side, the automatic employment of university graduates had been abolished during the current fiscal year, saving about LE 120 million. The number of government employees would not increase over the next five years, and civil servants were being retrained for other fields of employment, notably in industry and construction. In fact, the authorities were encouraging government employees to take early retirement from the Government in order to reduce the burden on the budget. Subsidies had been reduced significantly; for example, subsidies on bread had been reduced by LE 300 million in 1985 and further reductions of about LE 600 million were planned. Public expenditure had been reduced by 15 percent over the previous year. Public sector profits were increasing and the four companies still operating at a loss would be eliminated during the coming year.

On the revenue side, Mr. Hamed continued, the value of imports exempt from customs duties had been reduced from LE 2.9 billion to LE 2.1 billion between 1983/84 and 1984/85, thereby adding LE 700 million to government revenue. In addition, customs duties were being collected when the importer opened the letter of credit, which helped the importer to reduce brokers' fees and the Government to avoid delays in collecting revenue.

As to income taxes, a high percentage of the population fell under the exemption limit so that only about 2 million people paid taxes. The authorities were improving tax collection with assistance from various agencies, including the Fund, and renovating the administrative system as well as the customs tariff structure in order to increase revenue elasticity. Sales taxes had been expanded and were being changed from specific to ad valorem rates, thus reducing the budget deficit by LE 500 million, despite the decline in petroleum prices and Suez Canal dues. Despite that success, the authorities would strive to achieve rapid growth, better allocation of resources, and improved distribution of income.

The interest rate on savings cited in the staff report was the rate net of income tax, Mr. Hamed explained. In other countries, the rate of interest was the gross rate including income tax; in Egypt, the rate of interest on savings certificates--the most popular form of saving--was 13.25 percent net of tax. There were two taxes in Egypt: scheduled income tax--40 percent--and general income tax--10-65 percent. Once income was exempt from the scheduled income tax, it was automatically exempt from the general income tax. A net interest rate of 13.25 percent would be equivalent to a gross rate of 21.6 percent, based on general income tax rates of about 30-40 percent, depending on the income bracket. As interest rates in Egypt were far above the inflation rate, savings were encouraged. As a result, banks in Egypt had excess liquidity of LE 2 billion following their investment in different categories according to banking regulations. A method to encourage investment rather than savings was needed to channel those savings to productive investment. Thus, the rate of interest--high and without risk--was detrimental to investment.

The policies followed in the past two years by the Egyptian authorities were aggressive and comprehensive, Mr. Hamed stated. The authorities would continue to build on those policies and hoped that the support of the Fund under a stand-by arrangement and of the World Bank through investment assistance would provide the incentive for further adjustment.

Mr. Negm assured Executive Directors that the authorities were fully aware of the shortcomings of the present situation of the external sector. The authorities were moving toward unification, simplification, and flexibility in exchange rate policy. However, there were social and political limitations to the pricing impact of policy changes and the rate of exchange. The exchange measures taken in April 1985 had corrected some of the shortcomings of the January 1985 measures, which had been taken to restrict imports by eliminating the own exchange market. Meanwhile, the authorities' plans to implement a flexible exchange rate had not been carried out. The April measures had restored the own exchange market, providing more flexibility for the premium rate of exchange; that action was appropriate and had been welcomed by the people.

The Minister of Economy was at present discussing the cancellation of one of the bilateral payments agreements, Mr. Negm stated. As to the second bilateral payment agreement, a problem remained regarding the rate of exchange applied thereto; nevertheless, that problem could be settled in the near future.

The data provided by the Central Bank was the basis for the external debt statistics used by both the Fund and World Bank missions, Mr. Negm said. Although the statistical system was good, the authorities had requested assistance from the Fund to improve the method of recording and centralizing the statistics in the Central Bank External Debt Unit.

He appreciated Directors' comments on a program of adjustment for Egypt supported by Fund resources, Mr. Negm concluded. It was hoped that discussion of that program could take place in the Board soon.

The Acting Chairman made the following summing up:

> Executive Directors expressed broad support for the thrust of the views set forth in the staff appraisal of the report for the 1985 Article IV consultation with the Arab Republic of Egypt.
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> Noting the less favorable prospects for the main sources of Egypt's foreign exchange, Directors welcomed the greater awareness by the authorities of the need to address the structural weaknesses and distortions in the economy. There had been, since 1984, an important relaxation in the rigid pricing policies of the past--at both producer and consumer levels--and increased reliance on private sector initiative. Directors also noted the authorities' efforts to increase government revenue and contain public expenditure, including the decision to eliminate automatic employment of college graduates. Nevertheless, all Directors expressed considerable concern over the extent and severity of the domestic economic imbalances, the current weaknesses in the international payments position, and the less favorable prospects for the balance of payments over the medium term. Even after allowing for some possible pessimism in the staff's medium-term forecasts, and taking into account the social and political constraints, most Directors felt that the measures that had been taken so far were neither strong enough nor comprehensive enough to come to grips with the problems facing Egypt and to prevent further deterioration in the external payments position. Directors called for prompt and vigorous adjustment policies in the form of fiscal, exchange rate, and credit measures to slow the growth of aggregate demand and moderate pressures on the balance of payments, and fundamental actions across a broad front aimed at correcting structural problems.
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> While Directors welcomed the further price adjustments proposed by the authorities, they observed that most prices were still low relative to international prices for similar products, in particular, procurement prices for crops and energy prices. Further substantial adjustments were thus required to remove

relative price distortions that were misallocating resources, putting a substantial burden on the budget, and inhibiting the necessary supply response, particularly in areas such as agriculture. Several Directors observed that, given the size and pervasiveness of direct and implicit subsidies, a practical means should be found to direct them more exclusively to low-income families and to limit the number of subsidized items to a few essentials. It was further argued that inadequate or too slow action to reduce subsidies and to strengthen production incentives carried with it the danger that supply shortages might develop over time that would be undesirable socially and economically. Directors welcomed the proposed adjustment in domestic prices for petroleum products--although from a low base--and urged that the authorities press forward with the implementation and full pass-through of such increases at an early date.

With regard to fiscal policy, Directors welcomed the measures in the 1985/86 budget, including the containment in the growth of the wage bill, and urged that these measures be implemented without delay. In light of the magnitude and unsustainability of the financing gaps confronting Egypt, the overall budget deficit and the bank-financed deficits were still considered excessive. Moreover, it was urgent to improve the structure of the budget by increasing the elasticity of revenues relative to domestic income and by mounting a more extensive and sustained effort at containing the growth of current expenditures.

Directors noted with concern the decline in real public investment in recent years and underlined the importance of revising investment priorities, along the lines suggested by the World Bank, and of improving domestic resource mobilization. Comprehensive reform of the state enterprises, with World Bank assistance, was also strongly advocated, and ongoing steps at privatization were welcomed.

On the exchange system, most Directors expressed concern at the lack of progress in adjusting the official exchange rates, removing exchange restrictions, and unifying the exchange markets, and also at the accumulation of external arrears. The substantial overvaluation of the central bank and commercial bank rate, as well as the premium rate of the commercial banks, perpetuated inefficiencies in the tradable goods sector and placed further pressures on the balance of payments. Directors emphasized that the most effective way to reduce existing inefficiencies was to unify all markets into one rate, managed in a flexible manner, that would give priority to the need to revive non-oil exports; they welcomed the fact that the Egyptian authorities agreed with that basic position on the exchange regime. Moreover, the system should provide for immediate and full pass-through of exchange rate movements into prices. While a few Directors advocated caution and a step-by-step approach, most Directors believed that full unification cannot be postponed much longer, given the imbalances in the central bank market. The simplification of the exchange system and the adoption of realistic and flexible exchange rate policies would need to be accompanied by a reduction of import restrictions and a rationalization of tariff rates in order to prevent the creation of inefficient and internationally uncompetitive enterprises.

To support exchange rate measures and reduce pressures on the balance of payments and prices, Directors stressed the need for tighter credit and monetary policies, and they noted that recent developments moved in that direction. They encouraged the authorities to review the level and structure of interest rates in order to encourage financial savings in domestic currency, and cost capital at a realistic level so as to improve the allocation of credit.

Directors emphasized the importance of improving the quality of statistics, in particular those on external debt. They stressed the need to devise and adhere to precise and prudent guidelines on contracting external debt, as well as to settle all external payments arrears promptly.

Generally, the Executive Board has clearly indicated that it is acutely aware of the complex tasks facing the Egyptian authorities and that it welcomes the determination of the authorities to address these problems. However, several Directors expressed regret that the Egyptian authorities had not taken fuller advantage of the past years of balance of payments ease and rapid growth to tackle resolutely the rigidities and structural weaknesses that beset the economy. Since the internal and external imbalances were growing rapidly, Directors generally concluded that it was now urgent for Egypt to implement a vigorous and comprehensive package of corrective measures, which would have to be maintained and reinforced over the years, to arrest the deterioration in the balance of payments and correct the structural problems in the economy. The measures should aim basically at slowing the growth of domestic demand and reforming exchange rate, pricing, budget, interest rate, and investment policies so as to correct the consumption and production distortions that are undermining the external payments position. A clear and substantial shift in policies is needed now to give confidence to foreign financial markets and domestic business circles. Delays in implementation of such an adjustment effort would lead to an intensification of distortions and would render subsequent adjustment more difficult and painful. A number of Directors therefore expressed the hope that Egypt would soon adopt a comprehensive and vigorous adjustment program that could be supported by the use of Fund financial resources.

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

The Executive Board then took the following decision:

1. The Fund takes this decision relating to the Arab Republic of Egypt's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1985 Article XIV consultation with Egypt, in the light of the 1985 Article IV consultation with Egypt conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes the recent attempts made to improve the efficiency of the exchange system. The Fund considers, however, that the system remains complex and believes that further steps should be taken at an early date toward the complete unification of the existing rates. The Fund urges Egypt to settle promptly its external payments arrears. The Fund hopes that Egypt will terminate the two remaining bilateral payments agreements with Fund members as soon as possible.

Decision No. 8045-(85/123), adopted
August 7, 1985

2. SWEDEN - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Sweden (SM/85/205, 7/16/85; and Cor. 1, 7/29/85). They also had before them a report on recent economic developments in Sweden (SM/85/210, 7/24/85; and Cor. 1, 7/29/85).

Mr. Lundstrom made the following statement:

My Swedish authorities wish to express their appreciation for the stimulating consultation discussions with the staff mission and for the valuable observations made during these discussions and in the subsequent staff report. They are in broad agreement with the contents of the report and its analysis of the problems facing the Swedish economy.

The report gives a fair description of the main elements of the economic policy strategy pursued by the present Government since it took office in 1982. Its aim has been to expand production, investment, and employment, while restoring balance in the current account, reducing the budget deficit, and stabilizing price and cost developments. The main instruments used to achieve this aim have been the devaluation undertaken in 1982, restrictive fiscal and monetary policies, and measures to improve the supply side of the economy.

The Swedish authorities find that the report also gives a balanced assessment of the achievement of these policies over the past three years. The industrial decline has been reversed, subsidies to ailing industries have been discontinued, and a broadly based industrial restructuring is being achieved. Business profitability has been substantially improved, investments are expanding strongly, and unemployment has been kept down or even reduced. Considerable progress has been made in reducing the budget deficit, and the earlier trend of public expenditure growth has been broken. The current account has swung from a deficit of 3.6 percent of GDP in 1982 to about equilibrium in 1984. The results as regards costs and prices have until now been less satisfying, but a more marked deceleration of inflation currently seems to be under way.

These developments represent a fundamental reversal of the deteriorating trend in Sweden's economic performance since the mid-1970s.

As the staff rightly points out in its report, the main challenge for economic policy in Sweden is to ensure the sustainability of the present favorable trends and, especially, to tackle the problems in the fields where the results have not yet corresponded to ambitions.

Before commenting on the policies planned for the period ahead I shall provide some information on the most recent developments.

Recent developments

As noted in the report, the trade balance deteriorated in the early months of this year, primarily due to a faster than expected growth of imports based on rapid investment growth and stock building as well as stronger than expected private consumption. Exports increased only marginally during the first quarter of the year. The current account of the balance of payments showed a deficit of 12.5 billion kronor during the period January-May 1985.

Measures were taken in May to counter the emerging current account deficit and the currency outflow, which, together with concurrent conflicts in the labor market, risked impairing confidence in a further consolidation of the Swedish economy. The swift action taken--comprising firm credit policy measures by the Riksbank and restrictions on consumer credit, as well as some tax increases and the postponement of certain government expenditures--demonstrated the Government's resolve to defend its economic policy strategy and seems to have had the desired effects. From the time the measures were taken until mid-July, a currency inflow of 6 billion kronor has been registered. The swing to an accelerated inflow made room for a lowering of the discount rate by one percentage point on July 12; inflows since then have amounted to 1 billion kronor.

The trade balance showed an improvement in June, bringing the surplus for the first half year to 5.6 billion kronor. As a result of the improvement in the trade balance, the current account deficit for the first half year is estimated to be some 11.5 billion kronor. Judging from recent business surveys of investment and production plans, a marked slowing of import growth can be expected during the rest of the year, while exports should rise in line with earlier forecasts. The falling dollar is also having a favorable effect on the current account. It should therefore be possible to limit the current account deficit for the year as a whole to about 1 percent of GDP (in the range of 5-10 billion kronor).

The substantial government borrowing in 1985 is explained by two factors: a temporary response to the currency outflow in the period November 1984-May 1985 and a restructuring of the foreign debt of the Kingdom, taking advantage of favorable conditions for new borrowing. It should also be noted that a considerable part of the borrowed funds have been used to build up official reserves. Further repayments and a certain drop in the now increased reserves are planned for the remainder of the year.

As to prices and costs, there are now signs that a more marked deceleration is materializing. The price level actually fell during the early summer, due to the lowering of the discount rate in July and falling energy prices. The price level increased by 3.6 percent during the first half of the year, and the Swedish authorities expect that, given these developments and the moderate wage agreements concluded this year, inflation over the course of the year will be 5-6 percent.

Finally, since the staff report was written, additional information worth noting has been received on developments in two important fields. Unemployment was further reduced to a level of 2.6 percent of the labor force in June this year. In the field of government finances, preliminary calculations indicated a clear reduction of the forecast budget deficit for the current fiscal year, because of the lower interest rate level as well as the falling dollar.

Economic policy

The Swedish authorities agree with the staff that the main challenge for economic policy is to sustain the present favorable trends. As demonstrated through policy actions in recent months, the Government is firmly committed to its economic policy strategy and--as mentioned in the staff report--it will not tolerate a worsening of inflation and a growing current account deficit. In fact, economic policy will be designed so as to reduce inflation further and to eliminate the current account deficit. However, the Government rules out two options: the Swedish krona will not be further devalued, and there will be no resort to government foreign borrowing to balance an external deficit.

The 1984 Medium Term Survey, to which reference was made already during last year's consultations, outlines what would be required to put the Swedish economy on the path to macroeconomic balance in 1990. Its main conclusions have been adopted by Parliament as guidelines for economic policy in the years ahead.

The Government has consistently contended that full employment can only be maintained in the long run if inflation is brought down and domestic savings are strengthened. The Swedish authorities therefore agree with the staff that economic policy needs to be focused on two problems in particular: how to ensure a further deceleration of inflation and how to achieve a continued reduction of the budget deficit.

For results to be achieved on the inflation front, wage restraint is of decisive importance. As pointed out by the staff, the understanding reached between the Government and the social partners has resulted in a moderation of wage rises in 1985. The use of formal clauses in wage agreements linking the rate of pay to the cost of living or to wage developments in other sectors is now very limited. It is clear that there has been an increase in the general awareness of the problems posed by continued inflation and of the importance of wage restraint, and discussions are being conducted among employers and employees on how to bring wage developments in line with overall objectives of economic policy. The Government for its part has expressed its firm determination to avoid excessive wage cost developments in 1986 and onward.

A continued reduction of the public sector deficit is a necessary condition for a successful fight against inflation and a correction of imbalances in the external accounts. It is the stated aim of the Government to continue the restrictive fiscal policy it has been pursuing and to reduce the central government budget deficit further.

As to monetary policy, a major objective remains, of course, to reduce the overall high liquidity in the private sector. New market instruments have been introduced to attract different segments of the market. This policy has been successful in bringing down the money supply growth, but this must be seen against an increase in other liquid assets of the nonbank public. The authorities now place more emphasis on inducing buyers to acquire more long-term instruments.

Mr. Jaafar stated that he was pleased to note that the Swedish authorities' plans for reducing inflation and eliminating the current account deficit did not include either a further devaluation of the krona or foreign borrowing, both of which had been the subject of much discussion during the 1984 Article IV consultation. While inflation had moderated somewhat in 1984, the recorded 8 percent figure was not low enough by comparison with the average inflation rate in the industrial countries in that year. For the first half of 1985, the rate of price increase had slowed to 3.6 percent, with the prospect for a 5-6 percent rate for the year as a whole. However, that projection effectively meant that the earlier target of a 3-4 percent annual rate would not be met and, in his view, it was not likely that even the latest official projections could be realized, despite positive factors such as recent developments in oil prices and the downward trend of the dollar.

Among the factors that would more than offset any gains based on lower import prices were the 1985 price freeze and the recent public sector wage settlement, Mr. Jaafar said. The price freeze did not in any way lower prices; indeed, it only postponed the effects of price increases and distorted the market without satisfying the underlying demand. Furthermore, he expected a more intense pressure for price rises at the expiration of the freeze period. The recent public sector wage settlement, while within the authorities' 5 percent guideline, had not taken into account the likely substantial carryover into 1986 based on backloaded contractual increases. Moreover, it was likely that the private sector would follow suit with demands for wage increases. In that respect, the authorities and the staff were in agreement that appropriate financial policies would provide the necessary restraint on wages. However, the staff had indicated that if wage moderation could not be obtained, the authorities should perhaps tolerate a higher rate of unemployment, a point that brought to the fore the issue of the tradeoff between unemployment and inflation. It was not clear whether the authorities were prepared to tolerate higher unemployment to achieve their inflation objective, bearing in mind that Sweden currently enjoyed perhaps the lowest unemployment rate in Europe.

While welcoming the indication by Mr. Lundstrom that the current account deficit for 1985 as a whole would be limited to about 1 percent of GDP, approximately the same ratio registered in 1983, Mr. Jaafar said, it was disappointing that the current account balance had deteriorated markedly from the surplus achieved in 1984. The large inflow of imports was worrisome, coming in spite of the competitive edge enjoyed by Sweden since the recent devaluation; he agreed that the inflow pointed to a less than adequate response on the supply side, particularly with respect to the scope for expansion of investment. Because of the constraints imposed by special circumstances--particularly a tight monetary stance aimed at stemming capital outflows--domestic interest rates had been high and investment had remained subdued. However, since July 1985, conditions had changed and cash inflows had accelerated, a development that should allow more room for interest rates to ease somewhat and for private investment to grow.

Although Sweden's external debt in relation to GDP was small by comparison with that in some other countries, the debt service ratio was high at 18 percent, Mr. Jaafar observed. While applauding the authorities' commitment not to resort to external financing of deficits, he failed to see how that approach could be avoided in the medium term unless they were successful in eliminating the current account deficits, an ambitious goal in that it demanded that the Government hold the line on domestic costs and prices.

The tax reform implemented in the period 1983-85 had included a significant milestone in the lowering of the high marginal income tax rate, Mr. Jaafar said. Unfortunately, progress in reducing the public sector deficit had been slow, and he was concerned about the staff's reference to the relaxation of effort on the part of the authorities. Given the already high tax burden, the scope for addressing the deficit on the revenue side was limited, and the focus must be on retrenchment of expenditures, especially since they were nearly 65 percent of GDP. Progress on the expenditure front would also give more room for expansion of private investment. In the circumstances, the reported absence of any major initiatives to reduce expenditure growth should be deplored, as should the proposed tax rebate for 1985.

The authorities' commitment not to resort to foreign borrowing would place a considerable strain on the economic system on account of the monetization of the deficit, Mr. Jaafar observed. The high stock of liquidity associated with the fiscal deficit had in fact been a destabilizing factor in Sweden, limiting flexibility in monetary policy and constantly risking capital outflows. The high stock of liquidity could unduly encourage imports and therefore increase inflation. Hence, it was important to continue the effort toward financial market deregulation. The latest moves to free bank loan rates and create new market instruments were steps in the right direction that should allow for a more effective working of the open-market operations. In the end, of course, the solution lay with the effort to balance the budget. Finally, the authorities were to be commended for having resisted protectionism, especially with respect to trade with developing countries, and for Sweden's excellent record of official development assistance; he hoped other industrial countries would look to that record as a model.

Mr. Goos said that he welcomed the impressive progress made by Sweden in 1984 toward improving economic performance. As noted by the OECD, Sweden was one of the few countries that over the past two years had succeeded in restoring external competitiveness, profitability, and current external equilibrium and in progressing toward structural adjustment without incurring a major rise in unemployment. The authorities should be commended for that outcome.

Unfortunately, Mr. Goos continued, more recent developments in Sweden revealed disturbing trends in a number of areas crucial to economic stability. As illustrated in Charts 7 and 8 in the staff report, for example, recent unfavorable developments in the areas of wages and prices could, if not contained, undermine the competitive edge gained through the 1981 and 1982 devaluations, which were cornerstones of improvement in Sweden's overall economic position. The potential for adverse repercussions on growth, employment, and the level of public sector debt had been adequately covered in the staff report in the chapter on medium-term prospects, in which, a clear case for intensifying the stabilization effort had been made.

He was pleased to note from Mr. Lundstrom's statement that the staff and the authorities were in close agreement on the appropriate course of policy in Sweden, Mr. Goos remarked. Still, there were areas in which the results of economic policy followed thus far "have not yet corresponded to ambitions." The rather relaxed stance of fiscal policy at present, for example, seemed to be at variance with the Government's stated aim of maintaining restrictive financial policies, which, according to Mr. Lundstrom, were "a necessary condition for a successful fight against inflation and a correction of imbalances in the external accounts." In that context, he was concerned about the ruling out of any easing of the total tax burden in the years ahead and about the possibility that indirect taxes might be further increased. It was difficult to reconcile such a policy stance with the accepted need to further strengthen the supply side and reduce the Government's share in the overall economy. He was of course aware of the difficulties in cutting public sector expenditures in an election year; nonetheless, there was a risk that the necessary corrective measures might be implemented too late if they were postponed until autumn, particularly given the need to contain the emerging wage pressures through sufficiently restrictive fiscal policies. Timely action on the fiscal front could relieve the authorities' concern about monetary policy becoming too restrictive, inasmuch as it might increase the scope for lowering interest rates. By contrast, without a more balanced distribution of the adjustment burden--as between monetary and fiscal policy--any easing on the monetary side--such as had occurred with the lowering of the discount rate in July 1985--might again turn out to be unsustainable.

Continued wage restraint was crucial to the attainment of the authorities' main economic objectives, Mr. Goos considered. While he understood the reluctance to become overly involved in wage negotiations between the social partners, he felt that the authorities had an important role to play in influencing wage settlements by providing appropriate signals. He was not certain, however, about the appropriateness of granting tax rebates to wage earners in exchange for their consent to moderate their wage demands; while such an approach had perhaps led to the desired moderation in wages thus far in 1985, it was questionable whether it was viable on a more permanent basis. The point was that any further tax cuts aimed at moderating wage increases would require proportionately greater restraint on public expenditures so as not to jeopardize the fiscal consolidation effort.

For the staff to elaborate on the objectives for the special investment and renewal funds and to analyze their impact on the efficiency of resource allocation would be welcome, Mr. Goos said. He was concerned about the regulatory nature of those funds and would have thought that the investment objectives could perhaps have been attained more efficiently through voluntary and more market-oriented means if appropriate incentives had been in place. In conclusion, he joined others in commending Sweden's active commitment to the principles of a free trading system and its outstanding record on official development assistance.

Mr. de Forges observed that Article IV consultations with Sweden had evolved in an interesting fashion over the past few years. The Board had early on expressed its concern about the performance of the Swedish economy, which had been handicapped by years of fiscal complacency and external imbalances, accompanied by a deterioration in the competitiveness of the productive sector and considerable rigidities. The Board had noted the revival of the industrial sector and the improvement of international competitiveness, following the authorities' implementation of adjustment measures, and had commended the authorities for the good budgetary performance. Then, in 1984, the Executive Board and the staff had expressed concern about the pace and sustainability of the upswing in Sweden, particularly in view of capacity constraints and inflationary pressures.

In assessing the latest developments, Mr. de Forges continued, he was pleased to commend the authorities for the success of their policies. Adjustment required time to work through the various structural difficulties, and perseverance in the implementation of policies was often as important as the strength of specific measures. The Swedish authorities had initially displayed both the willingness to adopt strong measures and the perseverance to continue implementing them. However, as noted in the staff report, the discipline had weakened in 1985, at least through May, and Sweden had been confronted inevitably with a rapid deterioration in the current account and an increase in inflationary pressures. The policy package put together in May to combat those difficulties was a strong one. Particularly welcome was the focus on reductions in the public sector deficit, not so much because that deficit was especially high by international standards but because its reduction sent the appropriate signals in response to an overheating economy. The measures taken on the monetary side had also been well designed to reinforce those signals.

The authorities and the staff were apparently in agreement that the krona was currently at an appropriate exchange rate level, a view not shared by some Directors in the past, Mr. de Forges observed. The emphasis placed on the development of the financial market was welcome, as was, more generally, the policy of financial liberalization, which included the deregulation of the credit system and the draft law authorizing foreign banks to operate in Sweden. As for the efforts to counter inflation, he agreed with Mr. Lundstrom on the importance of wage restraint and welcomed the determination of the Government to avoid excessive wage costs in future. In conclusion, he was pleased to note the growing flexibility of the economy, which was particularly commendable in view of the high level of employment in Sweden. Continued strong employment should strengthen the favorable medium-term trends in the economy.

Mr. Schneider observed that by comparison with a number of other small industrial countries, Sweden's economy had performed well over the past two years. The mix of supply-side measures and relatively tight financial policies implemented following the devaluation of the Swedish krona in late 1982 had enabled the authorities to make significant progress toward restoring both internal and external balance while maintaining a satisfactory expansion of domestic production. In 1984, a small surplus had been registered in the current account; the central government deficit, which had peaked at 13 percent of GDP in 1982/83, had fallen to about 8.5 percent of GDP; the favorable business climate had permitted industrial production to increase by nearly 13 percent over the two years 1983 and 1984; and the relatively low unemployment level had been further reduced to less than 3 percent.

The main challenge facing the Swedish authorities at present was how to sustain the progress made since 1983, Mr. Schneider continued. During the previous Article IV consultation discussion, some concern had been voiced about the sustainability of the recovery. Developments in recent months suggested that that concern had not been entirely unjustified. The gradual loss of external competitiveness, the acceleration of consumer imports, the emergence of a sizable current account deficit in the first half of 1985, and recent difficulties in stemming capital outflows were all signs that there should be no relaxation of the adjustment effort. Moreover, some uncertainty existed about future economic developments, the staff's forecasts for the current account and domestic price developments were somewhat less optimistic than those of the authorities. He would welcome comment on those divergent expectations.

In his view, the causes of recent slippages were threefold, Mr. Schneider remarked. First, control of inflation and wage increases had been insufficient; second, the efforts to cut the public sector deficit had been relaxed somewhat; and, third, difficulties had been encountered in reducing domestic rigidities. Despite a fall in inflation in 1984, the rate was still too high by comparison with that in other industrial countries; the differential was gradually eroding Sweden's competitive edge brought about by past devaluations of the krona, and the current account was expected to slip again into deficit in 1985. The deterioration in the current account should be tackled through strengthened control over domestic costs and prices rather than through the use of the exchange rate; hence he welcomed the authorities' determination to avoid a further devaluation of the krona or a resumption of government borrowing abroad to finance the deficit.

A further and more drastic reduction in inflation would depend mainly on the ability of the Government to contain wage claims in Sweden, Mr. Schneider considered. In that respect, however, the outlook was uncertain. As noted by the staff, the authorities' relative success in containing the rate of wage increases in 1985 could result in considerable upward pressure on wages in 1986. In general the conditions under which the authorities must work in attempting to achieve firmer control over the wage determination process were difficult: traditionally, the Government did not intervene in wage negotiations, and the current economic environment of high business profitability and high employment was not conducive to a moderation of wage claims. Nonetheless, some intervention by the authorities might be required if the goals of full employment and viable economic growth were to be fulfilled in the longer run. One way to increase the awareness of the social partners about the tradeoffs between full employment and salary increases might be to impose cash limits on public sector personal expenditures, as had been suggested by the staff.

The struggle against inflation and accompanying wage claims would have to be sustained by a further reduction in the public sector deficit in order to meet the Government's own medium-term projections, Mr. Schneider commented. Initiatives to reduce the growth of public expenditure were needed in order to cool the overheating of the economy by reducing domestic demand and providing more room for an expansion of investment. Moreover, as pointed out in the staff's analysis of wage behavior and stabilization policies, the institutionalization of real wage disturbances in Sweden seemed to be closely linked to the stance of fiscal policy; and for some time fiscal expansion had cushioned the unemployment effects of real wage increases, nullifying an important avenue of adjustment. The present favorable economic situation seemed to provide an opportunity for reversing that trend.

The high stock of liquid assets built up in Sweden over the years posed a constant threat of capital outflows, Mr. Schneider noted. The efforts of the monetary authorities to reduce the rate of growth in the money supply through the creation of new market instruments and the promotion of long-term savings instruments were welcome. However, at least for the time being, the liquidity position of enterprises and households demanded the continued implementation of a cautious interest rate policy in order to avoid capital outflows and (to support the effort) to strengthen the current account. Such caution would not be easy for the monetary authorities because they could not rely too much on support from fiscal policy and must also keep in mind the potential adverse effects on high interest rates on investment.

He hoped that his remarks had not overly dramatized the problems facing the Swedish authorities as they attempted further to pursue their internal adjustment policies, Mr. Schneider said. The business and investment climate in Sweden remained sound, and economic prospects were favorable. Moreover, the authorities were well aware of the few weaknesses that he had mentioned, and he was confident that timely corrective measures would be taken. Finally, the Swedish authorities deserved commendation for having removed some existing trade restrictions and for contributing to official development assistance at a rate well in excess of the official UN target.

Mr. Ortiz observed that any evaluation of Sweden's economic performance must be undertaken in the framework of traditional policies aimed at maintaining an equitable income distribution and a low level of unemployment. Toward those ends, several supply-side and demand-management measures had been effectively implemented over the past two years and had contributed to improved economic performance and allowed the maintenance of high levels of welfare spending. The authorities had arrested the deterioration in the external position and had managed to reinforce the competitiveness of Swedish private enterprise while designing a medium-term strategy for industrial development.

In recent years, unemployment had been one of the most sensitive problems of European economies, Mr. Ortiz continued. Notwithstanding that a broad spectrum of policies had been applied to alleviate the problem, the unemployment rate had continued to increase, or had stagnated, even in countries that had shown signs of recovery. As with other European economies, the situation in Sweden had deteriorated in the late 1970s and early 1980s. However, the level of unemployment in Sweden had remained low in both absolute and relative terms. It should be borne in mind in that regard that Sweden had applied fewer restrictions than other countries on foreign workers so that in spite of rigidities in the labor market Swedish labor policies, including the system of taxation and benefits, had been largely successful in meeting basic objectives.

The sustainability of the favorable economic trends of the past two years was of concern to both the staff and the authorities, Mr. Ortiz remarked. In their view, the maintenance of full employment and the strengthening of the productive capacity of the economy over the medium term, aimed at ensuring the permanence of employment and welfare gains, could only be achieved through a lowering of the inflation rate and the strengthening of domestic savings. The authorities had indicated that they were determined to avoid utilizing foreign savings, thus aiming at balance of payments equilibrium; at the same time, they were keen on avoiding further exchange rate depreciations so as not to jeopardize their inflation objectives, particularly since the current level of the real exchange rate was consistent with an adequate margin of competitiveness and profitability of the export sector. Given the policy objectives and constraints set by the authorities, it seemed that the emphasis on augmenting the flexibility of wage negotiations as a way of countering inflationary pressures was well placed, as was the focus on gradual reductions of the public sector deficit as a way of strengthening the domestic savings base. Wage restraint and flexibility in sectoral wage negotiations appeared to be a key element in achieving the goals set by the authorities. In particular, wage flexibility across different sectors and industries should permit the swifter reallocation of resources toward more productive activities, thus minimizing traditional costs in terms of unemployment. It was comforting to note from Mr. Lundstrom's statement that various sectors of Swedish society were well aware of the importance of maintaining wage restraint and avoiding rigid links between wage developments and cost of living changes. Their awareness should facilitate further understandings between the Government and the social partners.

The authorities had reacted promptly and strongly to early signs of weakening in the external position, Mr. Ortiz noted. The monetary and credit measures adopted in response to the worsening of the current account and the capital outflows in the first months of 1985 had been most appropriate, and a reversal of the unfavorable trends had already been observed. Of course, an inevitable by-product of monetary restraint was a rise in interest rates, which, if sustained, could cloud the investment prospects for the second half of 1985 and 1986. However, the prompt actions taken by the authorities and their determination to pursue the goals consistent with their medium-term strategy were confidence building factors, which might permit an eventual lowering of interest rates without provoking capital outflows. That confidence would be reinforced, moreover, if negotiations on the wage front were conducive to a permanent lowering of inflationary expectations.

The Swedish authorities should be commended for their continued concern for the difficulties of developing countries, especially those at the lower end of the income spectrum, Mr. Ortiz concluded. His authorities hoped that other industrial countries would follow the Swedish example in official development assistance, especially in light of the enormous economic difficulties currently facing many developing countries. His authorities also welcomed the Swedish stance on trade and protectionism.

Mr. Alfidja observed that the Swedish authorities had made great progress since 1982 in restoring the economy's internal and external balances. The overall public sector deficit had shrunk from 6 percent of GDP in 1982 to 3 percent of GDP in 1984, and the current account balance had moved into surplus following several years of deficit. While the policies adopted by the authorities had on the whole been successful in improving general economic performance, certain areas of weakness remained. In 1984, inflation had been relatively high at 8 percent, while unit labor costs in manufacturing had been on the rise. It was thus reassuring to note from Mr. Lundstrom's statement that there had been some deceleration in costs and prices in the first part of 1985, which should improve the chances for noninflationary growth in future.

Given the structure of the labor market in Sweden, the success of policies aimed at restoring economic growth had created the conditions for an upward push on wages, Mr. Alfidja noted. Specifically, higher capacity utilization had led to an increase in business profits and to the emergence of a shortage of skilled labor; and the combination of those factors had put some upward pressure on wages in 1984. He was thus pleased to note that wage agreements had been moderate in 1985 and that the authorities attached great importance to wage restraint.

The authorities should be commended for having sharply curtailed monetary financing of the overall public sector deficit, which itself had been reduced by more than half in a period of three years, Mr. Alfidja remarked. However, the deficit for the next fiscal year had been projected to remain unchanged, which might be indicative of a relaxation of the adjustment effort. It was thus encouraging to hear from Mr. Lundstrom that the latest preliminary calculations pointed to a reduction of the projected budget deficit. Still, he agreed with the staff that the deficit needed to be further reduced and that efforts should be concentrated on reducing expenditure rather than increasing revenue. With public sector revenue at nearly 62 percent of GDP, the scope for reducing the deficit through increased taxes was limited. Furthermore, as the experience of the past year had shown, a reduction in taxes could be an important inducement toward scaling down wage demands.

Monetary policy in 1984 had been restrictive, as evidenced by the low growth of monetary aggregates, Mr. Alfidja commented. The measures introduced in early 1985 aimed at deregulating the credit system and increasing interest rates were welcome. Besides reducing capital outflows, those measures should help to strengthen savings and thus provide the necessary financing for the required growth of investment. Finally, the Swedish authorities should be commended for their commitment to a free trading policy and for their exceptional record in the field of official development assistance, much of which had been provided in the form of grants.

Mr. Murakami observed that Sweden's economic strategy since 1982, characterized by a large devaluation and aided by a recovery in world demand, had brought about a strong recovery in the economy and a marked improvement in the current account of the balance of payments in 1983 and 1984. The rate of unemployment had remained fairly low, and the level of youth unemployment was particularly low by international standards; a relatively high rate of inflation had persisted in 1983 and 1984 and the external current account balance had worsened rapidly since the beginning of 1985. The recent deteriorating trend of the balance of payments, although subdued in June, together with the already high level of external debt and debt service ratio in Sweden, had created uncertainties about the future of the Swedish economy.

At the root of those slippages was a resurgence of wage demands in 1984 and the upward pressure on price developments exerted by the lagged effect of the large devaluation of the krona in 1982, Mr. Murakami continued. Although the fiscal deficit had been reduced significantly in 1983 and 1984, there appeared to have been a relaxation of the effort in 1985, as evidenced by the expectation that the public sector deficit in relation to GDP would be roughly unchanged in 1985 from the previous year's level despite the strong recovery of the economy. Against that background, he could support the thrust of the staff appraisal and the conclusion that the authorities' adjustment efforts should be strengthened further, with particular emphasis on reducing inflation.

On the fiscal side, Mr. Murakami agreed with the staff that, in view of the high level of taxation in Sweden, further reductions in the public sector deficit should be achieved mainly through expenditure restraint, particularly in the area of government personnel expenditure. He joined others in supporting the monetary policy measures adopted by the authorities in May 1985 under circumstances in which fiscal policy had been making an insufficient contribution to the adjustment. Over the medium term, monetary policy would have to remain tight in order to reduce inflationary expectations and prevent an unduly large outflow of private capital.

The losses in competitiveness of Swedish exports incurred recently had been mainly associated with domestic factors, Mr. Murakami considered. Given the objective of reducing the rate of inflation and in view of the magnitude of the exchange rate devaluation in 1982, a further devaluation of the krona could not be justified as a way of dealing with the current account deficit at present. His chair welcomed Mr. Lundstrom's clear indication that a further devaluation of the exchange rate would be ruled out. The Swedish authorities had succeeded recently in promoting structural issues such as greater labor mobility and reduced subsidies to ailing industries. However, more remained to be done; in particular, various rigidities in the labor market should be tackled while the realization of adequate wage restraint should be achieved. The Government's guideline of limiting the growth of average wage earnings to 5 percent in 1985 was, according to the staff, consistent with development in unit labor costs and similar to the wage growth in partner trading countries. While the wage settlements in 1985 thus far appeared to have fallen within that guideline, a possible increase in wage drift would have to be taken into account. Moreover, future developments were subject to uncertainty, particularly in the broader context of the high level of employment and business profitability. It was thus all the more important that a favorable environment for wage restraint should be provided, inter alia, through appropriate financial policies. Finally, like others, he welcomed the authorities' continued commitment to the principles of free trade and their initiatives toward further progress in reducing protectionism.

Ms. Bush observed that during the previous Article IV consultation with Sweden, concerns had been expressed about the pace and sustainability of the recovery, and Directors had remarked on the need for a further reduction in the fiscal deficit and for wage restraint. The authorities had achieved considerable success in meeting some of those concerns, as evidenced by the strength of economic recovery and by fiscal performance, although progress in the area of wage restraint had been less encouraging. Real GDP had grown by 3 percent and domestic demand by 2.5 percent--quite good performance by international standards--with growth not overly dependent on foreign demand, Ms. Bush continued. However, the staff had identified uncertainties regarding wage and price moderation as the principal threats to sustained economic growth over the medium term. Productivity increases and a reduction in rigidities in the labor markets could of course play an important role in the achievement of a viable growth path. In that regard, the rise in investment in machinery and equipment by nearly 5 percent in 1983, by more than 10 percent in 1984, and by an anticipated 27 percent in 1985 was striking; she would welcome some indication of the extent to which such investment was labor saving, since that could have an important effect on future unit labor costs.

In contrast to many European countries, Sweden had been successful in generating new jobs over the past three years and in keeping unemployment at around 3-3.5 percent, Ms. Bush said. However, approximately 1.5 percent of the labor force was currently employed under relief work schemes, and a substantial part of the growth in employment had been in the public sector, in which employment had risen on average by 1.8 percent per year over the past four years and in which 31 percent of the employed labor force had worked in 1984. Moreover, and notwithstanding nearly full employment, new subsidies were being provided for recruitment for the private sector, and there was guaranteed employment in the public sector for 18-19 year olds. She wondered what other factors helped to explain the rapid rise in public employment and whether the authorities agreed with the staff that that rise should be reversed. She also wondered how public hiring policies could be reconciled with the need to achieve wage restraint. There had clearly been a major shakeout in employment in the mining and manufacturing sectors, reflecting the authorities' success in reducing excess capacity in such sectors as steel, mining, textiles, and shipyards, albeit at considerable cost in subsidies until the recent near elimination of such payments.

While the authorities had achieved some success in wage restraint to date, including a progressive move away from linking wage increases to the cost of living or to wage movements in other sectors of the economy, agreement on only an average wage rate increase in the 5-7 percent range in 1985 would not be very comforting, Ms. Bush remarked. Moreover, even that increase might not be achievable in a labor market in which shortages of skilled workers and technically qualified salaried employees were increasing along with business profitability and liquidity. The Government, as a major employer and potential wage leader, could play a key role in encouraging wage restraint in 1985 and over the longer term. Further reductions in labor market rigidities would help to assure an adequate supply response by the labor force to both overall demand for labor and to a more efficient allocation of labor resources. Furthermore, the alleviation of severe wage compression, greater labor mobility, reduction in the "tax wedge" between high labor costs and relatively low take-home pay, further reduction in high marginal personal income tax, and training and vocational education could all make useful contributions to the attainment of that objective.

The consumer price increase had been in the range of 8-9 percent over the past three years, Ms. Bush observed. And even if that rate could be reduced somewhat the achievement of the targeted rate of about 6 percent in 1985 would still leave Sweden on the high side of the range of rates among industrial countries. In that regard, the price freeze introduced in March 1985 would apparently be lifted later in the summer; but it was not entirely clear what would follow the freeze, and she would welcome further comment by the staff or Mr. Lundstrom on that matter.

Wage and price restraint must of course be supported by restraint in financial policies, Ms. Bush considered. In fact, considerable success had thus far been achieved in reducing the deficit of the public sector from nearly 6.5 percent of GDP in 1982 to only 3 percent in 1984. Most of the reduction in the deficit had been achieved on the expenditure side, as the ratio of expenditures to GDP had fallen by more than 2.5 percentage points between 1982 and 1984. Still, the ratios of both revenues and expenditures to GDP (60-65 percent) placed Sweden among those industrial countries with the very largest public sectors and highest tax burdens.

She welcomed the partial deindexation of some expenditures, the near elimination of industrial subsidies, and the requirement that new expenditure programs be matched with corresponding cuts in other expenditures or with revenue from new sources. In passing, she would be interested in hearing how well that latter requirement was working, especially since it was in her view less appealing. On the revenue side, she welcomed the cuts in personal income taxes over the three-year period 1983-85. While she remained concerned that 20 percent of all taxpayers continued to be subject to marginal income tax rates of more than 50 percent, she noted that nearly 85 percent had been in that category before the tax cuts.

Increased monetary restraint had played a useful role in Sweden in 1984, although the economy had continued to exhibit a high level of liquidity, and the authorities had found it necessary in May 1985 to take some strong monetary restraint measures, Ms. Bush recalled. Over the longer run, the recent financial market innovations in the form of an expansion in the array of debt instruments available to the public should help the effort to expand the market for equities and the availability of equity financing for business and pave the way for the entry of foreign banks into the Swedish market beginning in 1986. Nevertheless, it would be helpful to know more about the implications and future role of compulsory deposits by business and local governments in terms of their effect on monetary policy and as a source of business investment and funding for such items as research and development and labor training. Given the apparently satisfactory state of Sweden's international competitiveness, she agreed that the authorities should also resist any temptation to use exchange rate depreciation actively to offset continuous inflationary pressures, lest such action be interpreted as a relaxation of the authorities' anti-inflationary efforts.

In conclusion, Ms. Bush commended the authorities for their successes achieved to date but cautioned that the medium-term outlook could be threatened by inadequate wage restraint and by any suspension of the effort to reduce the fiscal deficit. She questioned the effect on long-term growth of the high tax burden in Sweden. As the staff had suggested, economic growth and external balance would soon come into conflict in the absence of any policy changes; hence, she hoped that strong new actions would be taken by the authorities over the next few months.

Mr. Joyce observed that, until recently, Sweden's economy had been doing reasonably well. The marked improvement in economic performance accompanying the major adjustment efforts in 1982 had continued through 1984. Industrial production, investment, and exports had all recovered strongly, and the generally low unemployment rate had further declined. Moreover, the large current account deficit had been virtually eliminated.

Developments more recently had been somewhat mixed, Mr. Joyce went on. The encouraging signs remained, including improved profitability and investment activity, but there had been disturbingly large wage settlements in 1984 and the first half of 1985; and the rate of price increase in 1984 had been double the targeted level. Moreover, the current account of the balance of payments had experienced rapid deterioration in early 1985. Together with the increasing evidence of re-emerging wage demands and inflationary pressures, that deterioration clearly indicated that Sweden's recovery was somewhat precarious, especially since growth was forecast to remain stagnant in 1985.

The Swedish experience seemed to confirm his view that a small, open economy could not allow its cost structure to move out of line with the cost structure in its major trading partners without severe consequences for the external balance, Mr. Joyce continued. Although the authorities clearly recognized the need to support the 1982 devaluation with firm demand management policies and longer-term structural measures, recent developments indicated that they would have to find better ways of keeping costs and prices under control and that they must move promptly to deal with rigidities in the economy, especially in the labor market. The measures announced in May 1985 represented a serious effort in the right direction but, as pointed out by the staff, much remained to be done.

Given the traditionally low unemployment rates in Sweden, labor market conditions had had little restraining influence on wage costs, Mr. Joyce observed. In addition, recent public sector wage settlements were likely to pose problems in 1986 and to trigger demands by private sector unions for "catch up" increases as well. In the circumstances, the authorities would have to be firm in resisting further upward pressures in the public sector. He could not accept the view that labor market difficulties could simply be left to employers and the trade unions to sort out; strong leadership by the Government was required as well. In that regard, he joined others in welcoming the progress already made in a number of sectors in cutting the links between cost of living increases and wages. Still, more progress needed to be achieved in reducing labor market rigidities and barriers to labor mobility. It was unsettling to note in that regard the shortage of skilled workers and technically qualified personnel in some areas; and it appeared that wage compression and a lack of adequate wage differentials might have introduced unfortunate rigidities and might be acting as a disincentive to the resolution of those problems.

The authorities had made good progress in reducing the fiscal deficit, Mr. Joyce considered. However, some signs of a waivering policy stance had emerged. For example, while no change in the deficit relative to GNP was expected for 1985, despite the economic upturn, the existence of the deficit would continue to draw on scarce domestic financial resources, thus limiting the scope for private sector investment. The authorities should thus resume the policy of deficit reduction. Clearly, the burden of adjustment could not be borne on the revenue side, since Sweden already had one of the highest levels of taxation among industrial countries; moreover, further tax increases might trigger higher wage demands. However, there was scope for major reductions in expenditures. Government spending at present accounted for nearly 65 percent of GDP, one of the highest rates among industrial countries. The authorities should perhaps consider cutting or eliminating industrial subsidies or reducing transfers. Postponement of certain expenditures as part of the main 1985 package was an important step in that direction.

Monetary policy in Sweden must remain tight, at least until more progress had been made on the fiscal front, Mr. Joyce noted. A large increase in interest rates announced in May 1985 undoubtedly had been necessary to stem capital outflows, but rates at such levels, if maintained, would pose a serious threat to future investment and growth. The problem seemed to be that undue reliance was being placed on monetary policy. Monetary management in Sweden was already seriously constrained by the high liquidity in the economy, injected in part by the fiscal deficit, and the prospect of further government deficits would only increase the strains on monetary policy. Hence, the level of liquidity in the economy must be reduced; if the Government could not tighten the reins on its spending, the only alternative was still tighter monetary restraint, despite the adverse side effects that such an approach would engender.

On the external side, Mr. Joyce observed, he had already touched on the requirements for firm wage policies and supportive demand management policies. Those measures were essential if the authorities were to avoid a further loss of competitiveness. Sweden had a history of devaluations designed to give the economy a competitive edge; while success with devaluations had often been achieved in the short run, the gains had frequently been only temporary, as rising labor costs and prices had quickly eroded the benefits of the devaluation. He was happy to see that the authorities recognized those dangers and that they were resolved to address the underlying problems. He also welcomed the assurances by Mr. Lundstrom that the Swedish Government did not intend to seek relief through further depreciation of the krona or through additional government financing abroad. In sum, while the authorities were continuing to make good progress toward reducing the major imbalances that had beset the economy throughout the late 1970s and early 1980s, the successes achieved over recent years must be consolidated if the economy was to benefit in a lasting way from the substantial depreciation in the krona that had already occurred.

Mr. Suraisry considered that the Swedish authorities should be commended for having reversed the deteriorating trends in the economy since 1982. In 1984, their policies had led to lower unemployment, higher growth, and a current account surplus. Equally important, the fiscal position had been strengthened, and steps had been taken to restructure the industrial sector. Notwithstanding the generally favorable position into which those impressive achievements had put the Swedish economy, the medium-term prospects were not encouraging. The rate of inflation remained high and could increase further, in view of recent wage demands and growing price pressures. Moreover, the momentum of fiscal adjustment had slowed in recent months. At the same time, the external current account had moved into deficit, despite the competitive advantage of Swedish manufacturers and strong external demand. The main task facing the authorities at present was to contain the growth in domestic demand

and to restrain wage and price increases. He was pleased to note from Mr. Lundstrom's statement that the authorities were committed to making more rapid progress in reducing inflation; it would also be important for them to promote further measures to ease supply rigidities.

The authorities should move more quickly toward their objective of reducing the budgetary deficit, Mr. Suraisry considered. In view of the relatively high level of taxation in Sweden, the focus of fiscal adjustment should be on expenditure reduction in order to provide room for new private investment while containing inflation. The authorities were well aware that a better balance between fiscal and monetary policies was desirable; the current policy mix, which relied heavily on monetary restraint, had led to high domestic interest rates, which could have a negative impact on investment. More emphasis should therefore be placed on reducing the fiscal deficit.

In the longer run, the achievement of sustained growth and external balance would depend on structural changes based on the principle of comparative advantage, Mr. Suraisry remarked. The Swedish authorities had succeeded in reducing capacity in unprofitable traditional industries and had shifted their industrial policy toward fostering innovation. By so doing, Sweden had set a good example for other countries with ailing industries. While Sweden's industrial policy should benefit the economy substantially over the long term, it appeared that more flexibility was still needed, particularly in the labor market where the compression of wage differentials and high marginal tax rates had contributed to a serious shortage of skilled labor. He encouraged the authorities to re-examine the current tax structure with a view toward creating more incentives for private sector initiatives and thus helping to create a climate for sustained growth over the medium term.

He supported the authorities' intention to avoid a further adjustment of the exchange rate; it would be more appropriate in his view to support the current rate with firmer domestic policies, Mr. Suraisry said. Also commendable was Sweden's aid record and its liberal trade policy, particularly toward developing countries. In conclusion, the authorities should renew their efforts in the months ahead to consolidate gains already achieved and to put the economy back on a path of steady, medium-term growth. With firmer domestic policies, that objective could be realized.

Mr. Wijnholds observed that while the Swedish authorities should be commended for reversing unfavorable trends in 1983-84 and maintaining low unemployment--in part through less rigid labor market policies than in many other European countries--the staff's warning concerning the risk of serious backsliding was appropriate. It was worrying to note that since 1984 there had been a regression in a number of areas and no further progress in others. The rate of inflation, which tended to exceed official projections remained roughly at the 8 percent level of 1984, while the price differential with Sweden's main trading partners had increased substantially. Although inflation had slowed recently, it would need to recede rather dramatically during the remainder of the year if the

5-6 percent target was to be achieved. Incidentally, that target was already higher than the 3 percent price increase that had been assumed by the authorities in drawing up their budget estimates. Also, the reduction in the public sector deficit, when adjusted for nonrecurrent factors, was modest. As a consequence, the already high ratio of government interest payments to GNP was likely to increase even further.

The staff had rightly stressed the need for continuing wage restraint and had outlined the longer-term consequences for employment if attempts at restraint should fail, Mr. Wijnholds remarked. Changes in the behavior of wages were essential if a repetition of the unfavorable developments over the decade up to 1982 was to be avoided. Unwanted increases in real wages were an important explanatory factor for those developments, although such increases had in fact been encouraged as well by policy responses.

The stated intention of the authorities to rule out a further devaluation of the krona and to avoid resorting to foreign borrowing to cover the external deficit was welcome, Mr. Wijnholds continued. If they fulfilled those intentions, more policy actions would be needed on the domestic front in order to counteract the serious deterioration of the current account, which seemed to be closely related to a weakening of the competitive position. According to nonofficial sources--which had in the past occasionally proven to be better forecasters than the Government--the deficit on current account was likely to be about 2 percent of GNP in 1985, nearly twice the deficit estimated by the staff and the authorities. A stronger anti-inflationary stance would thus be desirable. The authorities should resume their efforts to reduce the public sector deficit through further expenditure cuts; moreover, continued wage restraint was called for, particularly in the public sector, which employed no less than one third of the labor force; and improved control of the money supply should be maintained.

Monetary policy had traditionally not played an important role in Sweden, although a number of improvements had taken place of late, Mr. Wijnholds continued. With the development of new instruments, monetary policy had been tightened in May 1985, the monetary financing of the public sector had ceased, and the financial system had become less regulated. In that regard, he welcomed the intention to open Sweden to foreign banks beginning in 1986. Although the growth of monetary aggregates had slowed considerably, there remained ample liquidity in the private sector. While that clearly pointed to the need for continuing monetary restraint, it was not obvious what the authorities should aim for in precise terms; there was no monetary target, for example, although that need not be an omission in an open economy if there were some other anchor encouraging discipline. Such an anchor could be the exchange rate, and the authorities' stated aim of avoiding further devaluation could be taken as an expression of their desire to impart discipline through an exchange rate target. The authorities also intended to seal off the escape route of foreign borrowing, to which they had reverted to a considerable extent in the past. While their intentions were excellent, it was regrettable that the authorities had felt compelled to borrow abroad again earlier in 1985. Sweden's credibility would in his view be damaged if it began making exceptions to its stated policy on either the exchange rate or on foreign borrowing. The immediate cost of such a loss of credibility might be the maintenance of higher interest rates than would otherwise be necessary. Finally, he joined other Directors in supporting Sweden's liberal trade policies and level of official development assistance.

Mr. Zecchini remarked that Sweden had made significant progress toward adjustment in both the fiscal and external areas since 1982. At the same time, policymakers had progressively increased their reliance on market-based policy instruments, particularly on the monetary side, with favorable effects on the efficiency of the financial markets. Unfortunately, there were signs that the adjustment process might lose momentum before completion. The foreign accounts had shown a remarkable weakness in recent months, inflation had been proving less flexible on the downward side than anticipated, and the financial balance of the public sector was not expected to show much improvement in the course of 1985. Moreover, the authorities seemed unwilling to proceed further in the liberalization of the financial markets. He supported the staff view that the authorities must carry through with financial adjustment and liberalization and reverse the unfavorable tendencies emerging on the external front. Still, there were some points in the staff's analysis that must be qualified, particularly those relating to the anti-inflationary strategy, fiscal and monetary policy, and problems on the external side.

The staff had accurately observed that the inflationary performance of the Swedish economy in recent months had been disappointing, especially if the inflationary outcome was compared either with the authorities' objective or with the price performance of Sweden's main partner countries, Mr. Zecchini continued. The persistence of inflation was not surprising, however, if it was considered in the light of the sizable depreciations of the currency in 1981 and 1982, which might well have been a major factor in preventing further disinflation in the previous two years. At the same time, it had to be conceded that the depreciation and domestic inflation had been instrumental in producing a sharp increase in manufacturing profitability, which in turn had facilitated the recovery in industrial investment that had materialized in 1984. In any event, the persistence of inflation must be attributed to a number of elements and not solely to the lack of sufficiently firm financial policies.

Public finances should be one of the areas, although by no means the only one, on which future policy action should be concentrated, Mr. Zecchini considered. The staff and the authorities seemed to agree on the importance of emphasizing both incomes and financial policies, although the authorities only reluctantly accepted the use of the former, since it went against the principle that the Government should not interfere in wage negotiations. Consequently, a heavy reliance was placed on prudent financial policies, particularly fiscal restraint. Still, the choice of inducing wage moderation through financial policies alone was likely to imply a greater loss in terms of employment than would be necessary if the authorities were successfully to attempt some control over the dynamics of incomes. Put another way, he considered the use of financial policies alone insufficient to produce further significant progress against inflation if the level of employment was regarded as a target to be achieved at the same time.

On fiscal policy, Mr. Zecchini remarked that data from the past few years indicated strong progress toward adjustment, particularly if one looked at total public expenditures net of interest. On the revenue side, a remarkable change in the pattern of taxation seemed to have taken place with the reform of the personal income tax during the 1983-85 period. However, Table 18 of SM/85/210 showed no apparent change in the share of personal taxes in public sector revenue, implying that the reform had produced only a redistribution of incomes within the personal sector. In that respect, more detailed information on the authorities' views on the likely impact of the tax reform was necessary. It was often recognized that, in the Swedish case, stronger incentives to work were needed; but it was also usually believed that the response to such stimuli tended to be uncertain. That uncertainty was particularly evident at present since the reform had achieved merely a redistribution of income among taxpayers rather than on overall reduction in the fiscal burden on them. It would be interesting to know what objectives the Swedish policymakers wished to attain by the new structure of taxation and what mechanisms in the market were being employed to ensure that those objectives would be reached.

The consistency with which the authorities had moved in recent years toward a more market-oriented approach to monetary policy was commendable, Mr. Zecchini commented. They should be encouraged to proceed further, particularly with respect to ceilings on bank lending. In that connection, he had not been convinced by the staff's arguments in favor of credit ceilings; in particular, a high degree of liquidity of business enterprises should provide no justification for a greater effectiveness of credit ceilings versus interest rate changes in controlling the flow of expenditures of the enterprises themselves. On the contrary, if a business firm was very liquid, it would presumably feel little or no constraint initially from a restriction on the new credit that it could receive, while it could be quite sensitive to the opportunity costs represented by the interest rates on financial assets. Some clarification on that point would be welcomed, particularly since the problem of the excessive liquidity of enterprises seemed to be central to the entire philosophy of monetary policymaking in Sweden.

The staff had argued convincingly that the deterioration in the foreign accounts was the consequence of both the buoyancy of domestic demand and the loss in competitiveness, Mr. Zecchini noted. The latter problem, in particular, was well documented in the appreciation of the real effective exchange rate after the end of 1982. In the circumstances, the indication that the staff "welcomes the authorities' clear statement that an exchange rate adjustment should be ruled out as a way of dealing with the current account deficit" should be qualified. It would seem more appropriate to suggest that an exchange rate adjustment should be ruled out only as the main way of dealing with the deficit, since exchange depreciation should not be considered as an easy substitute for adopting appropriate monetary and fiscal policies. Furthermore, while it was possible to debate the advisability of devaluations of the extent that had been effected in 1981-82, particularly in the light of the difficulty of controlling the resulting effects on incomes, arguing against any exchange rate adjustment--after the underlying developments in relative prices and the consequent demand restraint policies had created the condition for such adjustment--seemed to be going too far.

Mr. Sengupta observed that based on the economic strategy followed by Sweden since 1982, it was expected that the external current account deficit would be less than 1 percent of GDP in 1985, inflation would be 5-6 percent, unemployment less than 3 percent, and the central government deficit less than 0.5 percent of GDP. Moreover, the consolidated public sector deficit would be less than 3 percent of GDP in 1985.

While performance on the employment front was remarkable by any standard, a shortage of technically qualified skilled personnel had been experienced, and the staff had argued that while training and a reduction in marginal income tax rates might help to meet the problem, the question of wage structure should also be tackled, Mr. Sengupta continued. Still, he wondered whether all those measures would help to increase the supply of labor at a rate that would help to meet the demands made on different degrees of skill.

Wage determination was a crucial element in the cost structure of the Swedish economy, Mr. Sengupta considered. The staff had stated that rapid progress in reducing inflation would hinge on developments on the wage front. Labor costs had not risen in 1984 because of the agreement between the Government and the social partners to limit the wage increases to less than 5 percent; however, the staff was concerned about the likely increases in wages in 1986, in part because of demand for some catching up by private sector unions and partly because of pressures exerted by high levels of employment and profitability. Thus far, developments had been favorable, with the elimination in recent wage contracts of former links to cost of living changes or to wage developments in other sectors. So long as those links were not re-established, wage restraint could be exercised and inflation rates could be controlled. Mr. Lundstrom had indeed provided a hope that the inflation rate would be less than 6 percent in 1985 as against the somewhat higher rate forecast by the staff. If that hope was realized, it would represent an improvement over price performance in 1984, when the inflation rate had been 8.1 percent.

The chances of keeping wages under control seemed good, as evidenced by the severe tightening of monetary policy in May 1985 and the adoption of modest fiscal measures, Mr. Sengupta remarked. Increases in official discount rates and penalty rates, the lowering of ceilings on lending, increases in compulsory deposits by business and local authorities, the raising of levies on automobiles, and the postponement of some central government expenditures were among the measures that had been undertaken. The beneficial effect of the tightening of financial policies could be seen in increased inflows in currencies since mid-May 1985, which had enabled the lowering of the discount rate by 1 percentage point on July 12. All those developments showed the need for a continuous financial restraint.

According to the latest information provided by Mr. Lundstrom, the current account deficit for 1985 might turn out to be only about 1 percent of GDP on the basis of expectations that performance in the second half of the year would help to reverse some of the less positive trends observed earlier in 1985, Mr. Sengupta said. Still, there was no doubt that Sweden's export performance would depend on its competitiveness, and he could thus understand the reasoning behind Mr. Lundstrom's indication that "the Swedish krona will not be further devalued." The authorities obviously felt that export competitiveness should be improved through other means. Moreover, the staff had observed on page 18 of the report that "another devaluation would signify defeat in the fight against inflation; its effectiveness is likely to be short-lived if wages cannot be adequately restrained or if the contribution of the public sector to the external current account deficit cannot be reduced." In that regard, the authorities were determined to keep wages restrained and to maintain a falling trend in the public sector deficit as a percentage of GDP. Devaluation with such restraints would surely have improved competitiveness but might have increased inflation to an extent that the authorities would not have found acceptable. While he had no difficulty with the staff's decision to agree with the authorities on the devaluation question, he hoped that similar conditional prescriptions against devaluation would be made in other deserving cases.

On the fiscal side, Mr. Sengupta remarked that while he was well aware of the large size of the Government, he found difficulty understanding the distinction outlined by the staff between the Central Government and the consolidated public sector. Expenditure restraint rather than revenue increases through further tax collection had been emphasized as a way of dealing with the central government deficit, which was projected at 8.5 percent of GDP in 1984/85 and 7 percent of GDP in 1985/86. However, Mr. Lundstrom had indicated that the deficit for 1984/85 might be less than 8.5 percent, due to the lower interest rate level and the falling dollar. His chair generally was not unduly perturbed by the size of public sector deficits, recognizing as it did that public expenditure was not necessarily always wasteful and could, in many cases, provide the essential stimulus to grow. However, he was certain that those who normally were disturbed by large government deficits would find one equivalent to 8.5 percent of GDP to be large indeed; and it was no comfort to know that the overall public sector deficit was equivalent to only 3 percent of GDP, because the difference was based on a substantial surplus in the social security sector, where a deficit would have been more justifiable from the point of view of the economics of welfare.

The ratio of Sweden's net external debt to GDP had not exceeded 24 percent in recent years, and the debt service ratio had been about 18 percent in 1984, Mr. Sengupta observed. He found intriguing the statement of the staff that "the size of Sweden's foreign debt and the proportion of current receipts absorbed by interest payments are such that a cautious approach to external borrowing is called for." He was curious about what weight had been given to those variables that had triggered such caution. Finally, he commended the Swedish authorities for having maintained official development assistance at 1 percent of GDP in 1985/86, for according priority to assisting Africa, and for resisting protectionism.

Mr. Salehkhou observed that Sweden had achieved impressive economic progress in 1983 and 1984, reversing the prolonged deteriorating trend in performance experienced in the late 1970s and early 1980s and introducing a significant adjustment in the economy's domestic and external imbalances. Except for the effort to contain inflation--which had been rather disappointing in view of the authorities' targets and the rates prevailing in most industrial countries--economic and financial performance had improved markedly in 1984 as a result of the strong adjustment measures implemented since 1982 and, to some extent, as a result of the recovery in foreign demand. In particular, significant industrial restructuring--which had arrested the decline in that area--had been accompanied by a satisfactory real growth in GDP, a significant curtailment of the Government's financial deficit from 6.4 percent in 1982 to 3 percent in 1984, and an elimination of the external current account deficit over the same period. Finally, open unemployment had declined to a level below 3 percent, paralleling the recovery in production and investment and further improving Sweden's excellent employment record among the industrial countries, despite the economy's high rate of participation.

Against the background of commendable economic performance since 1982, the concerns expressed by Directors during the 1984 consultation about the sustainability of improvements continued to be applicable to the short- and medium-term prospects for the Swedish economy, the more so because external performance had weakened somewhat in the first months of 1985 and there had apparently been some relaxation of the fiscal adjustment effort, Mr. Salehkhou observed. Moreover, signs had emerged of some supply constraints as well as renewed wage pressures, which might hamper investment recovery. It should be noted in that regard that, while the authorities seemed broadly to share the staff's concerns and recommendations, they would probably find it necessary to delay the required adjustment action until after the general election later in the year.

A major concern for 1985 was the re-emergence of a sizable external current account deficit, paralleling the surge in imports, and the possible resumption of growth of foreign debt, Mr. Salehkhou commented. As indicated by the staff, the deficit was occurring in spite of improved external competitiveness and business profitability. Although higher imports reflected to some extent the impact of exceptional factors, such as the severe winter in 1985, they were also indicative of the additional financial adjustment required. Improvement in the external outlook would apparently require a further tightening of fiscal policy and continued monetary restraint to check the economy's excess liquidity. While recourse to the exchange rate instrument might have worked in 1982, such a course of action might not be appropriate at present, considering the adequate competitiveness of Swedish exports and the impact a new devaluation would have on private capital outflows.

It might be difficult to improve public finances through an expansion of revenues, action that would increase Sweden's already high tax burden and might upset the authorities' efforts to contain wage pressures, Mr. Salehkhou observed. The focus should be on reducing government spending and accelerating retrenchment efforts in the public sector. While easing the excessive tax burden might have positive effects on the investment and production outlook, concern for the public sector deficit would obviously rule out action in that regard at present.

On the monetary side, the objective with respect to the private capital balance had required the maintenance of relatively high real interest rates, which were likely to have adverse effects on both investment and the anti-inflationary effort, Mr. Salehkhou continued. The authorities' room for maneuver in that area seem limited, given interest rate differentials vis-à-vis other industrial countries and the excessive liquidity accumulated over the years on the basis of expansionary policies. However, further progress in reducing inflation was crucial for the preservation of external competitiveness and for the containment of wage demands through the elimination of their links to the consumer price index.

In conclusion, Mr. Salehkhou commended the Swedish authorities for their exemplary and generous record of official development assistance. Despite a substantial curtailment of government spending, and in contrast to the level of assistance provided by most industrial countries, Sweden's official development assistance remained far above the UN target and was directed in particular at the poorest among aid recipient countries.

Mr. Mtei welcomed the impressive performance of the Swedish economy, the authorities' strong commitment to free trade, and the country's exceptional record on official development assistance. The reversal since 1982 of the deteriorating economic trend that had plagued the economy since the mid-1970s was indicative of the success that had been achieved in the management of the economy. For 1984, economic activity had been buoyant, with GDP having recorded a 3 percent growth rate, up from a 2.5 percent rate in the preceding year. The current account of the balance of payments, which had registered a deficit equivalent to 3.6 percent of GDP in 1982, had been in balance in 1984; and the deficit of the public sector had improved considerably. He agreed with Mr. Lundstrom and the staff that a further deceleration of the rate of inflation and a continued reduction in the budget deficit must be the priority goals of the authorities.

The prospects for the Swedish economy in the years ahead were encouraging, although much depended, inter alia, on wage and cost developments, Mr. Mtei remarked. Given the surfeit of liquidity and the high level of employment and business profitability, the authorities must avoid pressure for wage increases, which could lead to a decline in production and employment and could undermine the competitiveness of Swedish exports. Part of the solution to those related problems lay in the continued pursuit of appropriate fiscal policies. Measures already to achieve fiscal balance had resulted in the welcome reduction of the overall deficit from 6.4 percent of GDP in 1982 to 3 percent of GDP in 1984. Also welcome were the changes in the financing of the deficit, which currently relied mainly on borrowing from households and the nonbank public rather than monetary financing and foreign borrowing. The merit of the new system of deficit financing was that it assisted in mopping up excess liquidity in the economy.

The elimination of subsidies should help to reduce pressure on government expenditure, Mr. Mtei noted. Uncompetitive and inefficient industries would naturally be phased out, while others would survive mainly through innovation in research and development. His authorities commended the Swedish Government for discontinuing subsidies to ailing industries, an action both socially and politically sensitive but economically expedient.

Based on his understanding of current economic conditions in Sweden, Mr. Mtei agreed with the staff and Mr. Lundstrom that monetary policy would need to remain supportive of the restrictive fiscal stance. The overall high liquidity in the economy was a major problem, requiring a combination of public sector expenditure cuts and a mopping up or stabilization of the excess liquidity through tight monetary policy if inflationary expectations were to be reduced. In that regard, he supported the measures adopted in May 1985 to reduce private consumption and imports and to reverse capital outflows. On a cautionary note, he observed that while a severe tightening of financial and monetary policies might well arrest a deterioration in the balance of payments, it would not do so without also producing a decline in real GDP and employment. That trade-off underscored the need for an appropriate mix of fiscal and monetary policies.

As in the previous consultation, the staff was worried about the sustainability of the current favorable economic performance in Sweden because "the Swedish Government faces another uphill battle in its attempt at restraining wage claims," Mr. Mtei went on. He did not share the staff's concern, however, in part because he found the current package of fiscal and monetary policy measures to be appropriate and because he was convinced that the authorities were determined to maintain wage restraint.

On pages 15 and 16 of its report, the staff had provided details of measures taken by Sweden to foster the course of free trade, Mr. Mtei observed. Those measures covered a wide range of areas of interest to developing countries, and his authorities were happy with Sweden's commitment to global trade free from discrimination at a time when some larger and stronger economies found it increasingly difficult to avoid protectionism. Furthermore, Sweden's excellent official development assistance record with emphasis on African countries deserved commendation and emulation by others.

The Deputy Director of the European Department, responding to a query from Mr. Goos on the effects of investment and renewal funds on the allocation of investment, observed that investment funds were a Swedish tradition dating back to the 1930s, when they had been used mainly for anticyclical policy. At present, they played a quite different role. It was tax advantageous for companies to build up investment fund deposits which could in time be used for domestic investment and other employment-creating purposes. Compulsory liquidity deposits at the Riksbank had been instituted with the aim of allaying the fear of the unions that a high level of profits by enterprises might be used for purposes other than investment or employment-creation. Of course, since money was fungible, the effectiveness of the measure was questionable. Thus, investment funds were quite different from the compulsory liquidity deposits (referred to by Ms. Bush) which called for deposits in the central bank of a share of the liquidity held by enterprises. As Ms. Bush had correctly noted, that requirement was a monetary policy measure, but it also had fiscal effects since such deposits were used to finance part of the deficit of the Government at below market interest rates; the measure was also one way of reducing and then stabilizing the high level of liquidity held by enterprises.

On the differences in forecasts by the staff and the Swedish authorities, the Deputy Director noted that the forecasts for prices diverged, in part, because the staff had adopted a different assumption about wage developments. The staff believed that because of tightness of the labor market and buoyant profits of enterprises, wage drift was likely to be high and, as a result, the increase in earnings would be greater than the 5 percent assumed by the authorities. The staff assumptions for productivity--also less optimistic than those of the authorities--seemed to have been supported by developments in production in the first few months of 1985. The staff had also taken into account the effects of the price freeze; to the extent that that freeze had had some impact in the first half of the year in holding prices down, the partial or complete lifting of the freeze in the second half of the year was likely to lead to increased inflation. In general, the staff's forecast for infation was based on a recognition of what had happened thus far during the first half of 1985 when prices had increased by about 4 percent. In order to reach the official target of a 6 percent increase by end-1985, prices would have to rise by only 2 percent for the remainder of the year, a development the staff felt was unlikely.

The staff's forecasts of the current account were again a reflection of what had happened thus far in 1985, the Deputy Director remarked. For the first half of the year, the current account had registered a deficit of SKr 11.5 billion, in contrast to a surplus in 1984. The swing was equivalent to about 2 percent of GDP. Moreover, seasonal factors were expected to be unfavorable in the second half of 1985 and, even assuming a recovery of exports in the second half of the year, it was unlikely that the authorities would be able to reduce the current account deficit from its present level to the one officially forecast.

In response to questions raised by Ms. Bush, the Deputy Director stated, he would point out that some of the investment in machinery and equipment in Sweden was labor saving in nature. More remarkable, however, was that investment in building and construction had been far stronger in 1984 than investment in machinery and equipment, which seemed to indicate that a large share of investment was more of a capacity-expanding type. In addition, the Central Government was no longer following the practice of increasing public sector employment as a way of holding up overall employment rates. Still, employment by the local authorities was continuing to increase because of the policies to guarantee jobs at the local level to school graduates and to expand facilities for care of the elderly and day care for children.

The labor markets' main problem was related to rigidly narrow wage differentials, which had an adverse effect on mobility because the incentive for workers to acquire the necessary training and skills to move into new jobs was blunted, and to some extent productivity was adversely affected, the Deputy Director considered.

The authorities had the ability to finance new programs, the Deputy Director noted; the tax reform in Sweden had been fully financed by revenue measures taken in successive budgets in the past. In 1985, however, the situation was somewhat different. The tax rebate to wage earners had not been financed by expenditure reductions or tax increases; moreover, the planned simplification of the tax system, scheduled to be implemented on January 1, 1986, would result in a sizable reduction in revenue and was also not fully funded. The authorities had, in effect, used "bracket creep" or incomplete indexation of the tax brackets in order to finance some of the tax reforms.

As for the aims and effects of the tax reform, the Deputy Director remarked, the reform had been decided with bipartisan support in Parliament before the current Government had come to power; thus while the new Government had carried out the tax reform, it had allowed "bracket creep" to occur, which was a major factor why the share of personal income taxes in total revenue had not changed. As for the effects of the reform, the staff had indicated in its report that marginal rates had been reduced for a number of tax payers; and the simplification of the tax structure that was to take place in 1986 would bring to those tax payers in the lower brackets some of the benefits that in the past had been enjoyed mainly by those in the higher brackets.

On Mr. Zecchini's reference to the argument of the authorities that credit ceilings were necessary because of the higher degree of liquidity of the corporate sector and the lack of interest rate sensitivity of the demand for credit by households, the Deputy Director said, he agreed that the high liquidity of the corporate sector was not a good reason for using credit ceilings; in effect, enterprises were sensitive to the level of interest rates, whatever their liquidity. He also agreed with Mr. Sengupta that the effectiveness of measures to increase the supply of labor was likely to be limited, although they could help to reduce the time it took for enterprises to fill vacancies. Recently, the duration of vacancies had fallen significantly, in part because of the strong and deliberate effort of the authorities to improve training and labor mobility.

The authorities were concerned about the trend of debt, the Deputy Director noted. Their own projections showed that should large current account deficits be experienced again, the external debt in relation to GDP and the debt service ratio would go on growing to unsustainable levels. More generally, it was accepted that industrial countries should normally become net savers by accumulating foreign assets rather than external liabilities; and it was indeed a medium-term aim of the authorities to eliminate the current account deficit.

A few Directors had questioned the view that further devaluation of the krona should be avoided, the Deputy Director recalled. It must be recognized that Sweden was a country with near full employment and a strong competitive position, both of which characteristics weakened the case for a devaluation. Moreover, the use of exchange rate adjustment to correct a current account deficit that, at least in part, was due to public sector dissaving tended to be self-defeating, in the sense that the effectiveness of the devaluation would be rapidly eroded. Moreover, the continued existence of the public sector deficit would tend to cause the current account deficit to reappear. Finally, the Swedish authorities and the staff had recognized that the more often the exchange rate instrument was used, the less effective it became, as the lags between the improvement in competitiveness and the subsequent increases in costs and prices became progressively shorter.

Mr. de Maulde remarked that there was no clear evidence that the absence or narrowness of wage differentials in Sweden were in any way harmful to productivity; however, he would appreciate hearing further from the staff or Mr. Lundstrom on whether any other effects had been observed.

The Deputy Director of the European Department replied that significant shortages of skilled workers and technicians were evident in various parts of the Swedish economy; and it was the view of both the staff and the Swedish authorities that those shortages were due in part to the narrow wage differentials which, as he had indicated earlier, did not provide incentives for the acquisition of further skills or training.

Mr. Lundstrom said that the authorities in Sweden were becoming increasingly cognizant of the seriousness of the inflation problem and of the key role played by wage developments in the inflationary process. Even the head of the Trade Unions Reasearch Institute had observed that holding down cost increases in Sweden was the central economic problem at present. Also, in the tradeoff between inflation and employment, inflation was generally viewed not so much as the price to be paid for high employment as a threat to such employment. In that respect, the Government could usually count on broad support for, or at least understanding of, the policies needed to lower inflation in Sweden to the level in the main competitor countries.

In response to Mr. de Maulde's indication that there was no evidence to suggest that the narrowness of wage differentials in Sweden adversely affected productivity, Mr. Lundstrom observed, his Swedish authorities had begun to feel that the wage structure in general, and wage differentials in particular, were important factors; what was interesting was that the trade unions had begun to come to the same view.

On the timing and content of policy action that might be required in Sweden, Mr. Lundstrom noted, fiscal policy decisions would be taken in the autumn of 1985 in the context of the preparation of the next annual budget bill, but also possibly with respect to the package of budget measures that was traditionally presented to parliament when it assembled in October. Nothing could be said at present, however, about the precise composition of such measures. The staff had referred to the possibility of raising indirect taxes, although some speakers had warned against an overall tax increase. It was in fact the intention of the Government not to increase overall tax pressure.

A number of Directors, while welcoming the successful incomes policy attempted in Sweden in 1984, had wondered whether the wage restraint resulting from that policy might not create pressure for greater increases in the 1986 wage negotiations, Mr. Lundstrom recalled. As he understood it, consideration was being given to smoothing out the overhang from 1985 over a longer period, perhaps by means of a multiyear wage settlement. The official attitude to incomes policy generally was a cautious one, but that did not mean that the Government would accept excessive wage increases. Indeed, the Government had demonstrated its stance in that regard quite forcefully during the labor market conflicts in the public sector in May 1985. For the longer term, some institutional reform of the wage formation process was being studied, but it was too early to predict the outcome of that study. On the differences between the forecasts of the staff and the Swedish authorities, while he continued to believe that the staff leaned more toward pessimism, he conceded that the forecasts of the authorities, as they were gradually revised, had begun to approach those of the staff.

On the usefulness of comparative examinations of the experiences of countries that had adopted different key policy choices, Mr. Lundstrom remarked, the countries in such exercises must be selected carefully. They had to be comparable, and the policy differences had to be clearly identifiable and sufficiently significant. Moreover, allowance must be made for factors that distorted and blurred all such comparisons. Still, with those provisos and on the understanding that any conclusions drawn must be guarded and qualified, quite a few lessons might be drawn from such comparative analysis. Appendix I of SM/85/210, dealing with wage behavior and stabilization policies, was an illuminating example of the usefulness of such analysis. In general, it would always be less costly for a country to learn from the mistakes of others than to make those same mistakes itself.

The increased attention being given to structural and medium-term problems in consultation exercises was welcome, Mr. Lundstrom said. It was less difficult to point to economic policy measures designed to correct temporary fiscal and external imbalances than it was to analyze the underlying factors of a more structural or systemic character that were often at the root of the imbalances and that tended to make them more persistent or recurrent in some countries than in others. In the case of Sweden, for example, the authorities were well aware of the slippages alluded to by Directors and were in agreement with the staff on the character of the measures that should be adopted to correct them. In that respect, the staff appraisal served to underscore what was already widely accepted in Sweden, at least in broad terms. It was obviously much more difficult to deal in a longer-term perspective with the problems of institutional and structural constraints and rigidities and to discuss the consequences of different policy options and strategies, a fact that made it all the more heartening to see the Fund increasingly venturing into analysis of problems as fundamental as the importance of real wage gaps and wage differentials to the increase in noncyclical unemployment. The instructive study of Swedish labor market rigidities in Appendix II of SM/85/210 was an excellent example of the staff's ambitious analytical approach aimed at dealing more with medium- to long-term strategies than with short-term stabilization policies. The conclusions that could be drawn from that study, in his view, lay at the heart of the imbalances besetting the Swedish economy. Even if the conclusions were not particularly surprising, they were of great interest, not least because they were partly based on comparisons with other economies relying on different labor market policies.

In conclusion, and as a way of showing how closely the assessment of the Swedish authorities corresponded to that of the staff and the Executive Board, Mr. Lundstrom asked his colleagues to take note of the following excerpt from the 1985 revised Finance Bill:

> A sharp increase in wages and prices combined with accommodating financial policies leads to increasing imbalances, which in particular take the form of a high rate of unemployment and a current account deficit. Such developments are not sustainable in the long term. There is no possibility of raising the level of employment through expansionary policies aimed at increasing domestic demand. The current account deficit would increase to an intolerable level. Further, necessary adjustment to increasing costs will become more difficult. In that way, these policies would undermine their objective of an increased level of employment. Thus, in all respects, the economy would diverge from the desired equilibrium.

Nor can the problems posed by excessive wage and price increases be solved by another devaluation. The improvement in the competitiveness of the export sector would be short-lived, and various agents of the economy would be induced to expect continued price increases and further devaluations. Thus, price stability, a major objective of economic policy, would be surrendered indefinitely.

Against this background, the rate of wage and price increases has to be reduced substantially. Business profitability has to remain at a high level. The rate of increase of public expenditures has to be reduced, as has the central government budget deficit. Domestic demand developments have to be adjusted to the target of a balanced external account and the need for an increased level of employment. The labor market's ability to adjust and adapt has to be improved.

The Chairman then made the following summing up:

Executive Directors noted Sweden's impressive achievement between 1982 and 1984 in combining economic expansion with adjustment in the external current account. The improvement in competitiveness secured by the 1982 devaluation led to a marked rise in profitability and in investment and exports as well as a sustained recovery in industrial production. The removal of subsidies to ailing sectors of industry has helped to restructure industry in an efficient manner. Sweden's remarkably low rate of open unemployment was further reduced to below 3 percent during the period, while reliance upon relief work schemes declined. With the external current account in small surplus in 1984 and the public sector deficit having fallen to 3 percent of GDP--with each registering an improvement of 3 1/2 percentage points of GDP since 1982--Directors considered that imbalances within the economy have been substantially reduced.

Directors expressed concern, however, at the recent slippages in the adjustment effort, particularly the recent unsatisfactory performance in cost and price developments: inflation continued to be stubbornly high, and wage increases in 1985, following significant slippages in the previous year, were likely to be in excess of those in partner countries. Moreover, the recent public sector wage settlement raised the concern that there might be a substantial carryover into 1986. Wage drift in the private sector was also likely to be considerable, given the buoyant economic climate. Directors believed that financial policies must play a crucial role in setting the stage for wage restraint and they stressed that, if such restraint could not be effected, a higher rate of unemployment might become unavoidable. Directors urged the public sector to take the lead in securing pay moderation in 1986. In that respect, the Government's stated determination to avoid excessive wage cost developments in 1986 and beyond was welcomed, as was the indication that inflation was currently viewed in Sweden itself as a threat to full employment rather than as a price to be paid for its maintenance.

Remarking on the labor markets, Directors noted various rigidities and a lack of flexibility and mobility. Wage compression and high marginal tax rates were seen as contributing to shortages in certain sectors of the labor market. In addition, high rates of indirect taxes on labor appeared to have hampered labor market flexibility.

In order to achieve a reduction in the rate of inflation and to begin correcting the large external current account deficit registered thus far in 1985, Directors considered that fiscal policy should be tightened. Observing that fiscal consolidation had apparently come to a halt, in contrast to the Government's own policy aims, Directors considered it vital that the rising investment required for sustained growth should be financed through domestic savings, as Sweden's external debt and debt-servicing position made reliance upon further borrowing from abroad imprudent. They judged that fiscal restraint should center upon current expenditures--including public sector employment and wage payments as well as social subsidies and transfers--in view of the current onerous burden of taxation with its adverse effects on work incentives and capital formation and, as some Directors noted, given that public sector expenditure remained particularly high at nearly two thirds of GDP. Directors hoped that the authorities would be able to implement a fiscal package in the autumn adequate to turn around the external position, contribute to dampening cost and price inflation expectations, and return fiscal developments to the path set out in the authorities' medium-term strategy.

Directors considered that the May 1985 measures had been tilted excessively toward monetary restraint, with fiscal adjustment making little contribution. High interest rates were at present required to stabilize the external accounts and control domestic liquidity. However, necessary high rates might be in the current circumstances, Directors felt that they could not be maintained for long without a damaging effect on investment, a point which strengthened the argument for prompt fiscal adjustment. Directors also welcomed the steady deregulation of money and capital markets and the greater reliance upon open market operations and hoped that further progress could be made in those areas.

Directors observed that Sweden's recent experience demonstrated that, in a relatively small and open economy, slippages in the relative cost and price position are promptly reflected in a weakening of the balance of payments and economic activity. They welcomed the authorities' clear determination to maintain the central rate of the krona and to promote external adjustment through domestic cost restraint. They agreed with the staff that another devaluation would signify a defeat in the fight against inflation. Directors noted favorably the Government's objective of eliminating the external current account deficit and the determination of the authorities not to resort to official foreign borrowing to finance external deficits.

Directors commended Sweden's outstanding record on official development assistance as well as its firm commitment to a free trading system, and they welcomed Sweden's efforts at reducing worldwide protectionism.

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

3. PAPUA NEW GUINEA - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Papua New Guinea (SM/85/207, 7/18/85). They also had before them a report on recent economic developments in Papua New Guinea (SM/85/211, 7/26/85).

Mr. Romuâldez made the following statement:

On behalf of my Papua New Guinean authorities, I would like to thank the management and staff for the conduct of these consultations, which has been professional and efficient, yet not without a good measure of empathy. My authorities have always found these discussions fruitful. They regard the report as a fair representation of their dialogue with the staff. Through these exchanges, they have been able to focus attention on issues of significance confronting the economy and have been afforded analytical perspectives and insights which closeness to the day-to-day developments in the economy may have prevented.

My authorities share the staff's assessment of 1984 as having been a good year for Papua New Guinea's economy. Real GDP grew by 2 percent; indeed, barring the impact of investment cuts at OK Tedi, the growth of economic activity came closer to 6 percent. For the second straight year real incomes increased significantly. Overall employment registered modest gains as a result mainly of what are estimated to have been substantial increases in the agricultural sector, which offset a slowdown in general as well as OK Tedi-related construction activity. The overall rate of inflation declined to 4.4 percent; however, unless betel nut prices had moved erratically downward, the rate of inflation would have been higher, given upward pressure from import prices and brisk demand.

Papua New Guinea's terms of trade improved by about 10 percent during the year. Overall exports rose by 18 percent, with agricultural exports contributing substantially on the basis of a 60 percent expansion. The current account deficit of the balance of payments fell to the level of 13.6 percent of GDP. The overall balance of payments showed a surplus of about K 44 million in spite of some decline in net capital inflows associated with reduced foreign borrowings and equity investments principally related to OK Tedi. Gross international reserves were maintained at SDR 461 million, an amount equivalent to six months' imports.

The year 1984 saw fiscal policy stressing the same restraint initiated in 1982. The budget deficit was kept at 1.1 percent of GDP, as against the budgeted 3.2 percent and the 4.3 percent recorded for 1983. Revenues and grants grew by 14 percent even as expenditures increased by no more than 4 percent. With significant reductions in foreign commercial borrowings, the Government was able to realize net repayments of foreign commercial debts while improving nevertheless its net asset position in the banking system. Monetary policy remained accommodative, providing support for the upsurge in activity, particularly in the private sector, made possible largely, of course, by external demand conditions. Since the last Article IV consultations, however, following Board advice, my authorities have raised the required liquid assets ratio and, combined with lower levels of bank liquidity, it is now a more powerful tool for controlling credit expansion. On January 1, 1985, the Central Bank deregulated the passbook savings rate, completing thereby the deregulation of deposit rates. The partial wage indexation introduced in 1983 was maintained, as was the flexible implementation of exchange rate policy toward improved external competitiveness.

My authorities stress, however, that 1984 was not entirely rosy. The world recovery did not translate into any strengthening in the prices of minerals. Copper prices remained low as producers reduced stockpiles; the price of gold, of course, fell dramatically with the continued strength of the United States dollar. The most visible sign of the problems falling mineral prices caused for Papua New Guinea was the temporary shutdown and subsequent rescheduling of development plans for the OK Tedi Gold and Copper Mine. Delays in the construction of the tailings dam, the hydroelectric station, and the copper line brought investment down well below projected levels for 1984. Overall, my authorities say, the operation of the mining sector probably had a small negative impact on growth rates--this, at a stage in the development of the country when the minerals sector has grown in importance.

Prospects for 1985 remain mixed and problematic. Output and demand in the industrialized world are expected to increase further--albeit more slowly. Some acceleration in growth rates is forecast for developing countries. My authorities nevertheless forecast a decline of about 2 percent in Papua New Guinea's terms of trade with the prices of many agricultural products having peaked in 1984. Investment in agriculture has picked up markedly during the past year, and my authorities are hopeful that higher production levels will offset anticipated declines in returns from some crops. They expect, moreover, that aggregate growth and the balance of payments will be benefiting from the coming on stream of the first full year's production of OK Tedi. To be sure, prices are expected still to remain depressed in the minerals sector. A forecast lift in copper and gold prices remains uncertain. My authorities feel that the longer prices continue at current levels, the more serious the implications become for both new projects development and government revenues. The Minister of Finance, in his 1985 budget message to Parliament, emphasized that the success of the agricultural and mineral exporting sectors is necessary for the growth and development of Papua New Guinea; investment in these sectors will be a major determinant of the country's performance over the next few years.

The staff suggests, with no small measure of concern, that the 1985 budget "represents a clear point of departure from the policy of restraint followed during the previous three years." This cannot be gainsaid. My authorities would have it noted, however, that the 1985 fiscal position at the time of the mission was far more expansionary vis-à-vis the 1984 outcome than the position forecast at the time that the 1984 budget strategy was formulated. Lower than forecast expenditure levels and strong revenue receipts during 1984, together with worsening revenue prospects for 1985, have served to highlight the contrast. Indeed, in recognition of the situation, officials have been directed to cut K 15 million from nonconcessionary financial expenditure during the forthcoming quarterly reviews. Not without reason or urgency, my authorities have added another dimension to the emphasis of their policy objectives--namely, promoting economic growth and creating productive employment opportunities. Of late, the Government has had to confront growing unemployment, particularly in urban areas, and the many social problems that accompany it.

This is not to say that my authorities disagree with the staff on its assessment of the country's prospects or on its recommendations or that caution has been cast aside. Indeed, my authorities have tried to heighten their sensitivity to movements of economic indicators in order that should the need arise, they would be able more quickly to resort to planned contingency actions that would reduce expenditure or minimize pressures on the country's reserves position. They appreciate the staff's views on the uncertainties that threaten the medium term, but have been compelled into a more expansive stance by social circumstances. Given the still relatively comfortable position the economy is likely to enjoy in 1985, my authorities have decided to explore the possibilities of expansion this year without necessarily being committed to it. As the staff has indicated, my authorities' balance of payments scenario for the medium term must be regarded as illustrative and not as a realistic forecast outcome, "especially because they would not be willing to allow international reserves to fall below about SDR 300 million" and "as in the past, economic policies, including demand management, external borrowing, and exchange rate policies, will be adapted as necessary to ensure external viability."

The 1985 budget incorporates a 2 percent real increase in government expenditure on goods and services. The projected overall deficit is now estimated at 3.8 percent of GDP, representing a sharp increase from the 1984 level. It is hoped nevertheless that tight expenditure control along with more favorable revenue developments and Australian aid commitments will help bring the actual deficit to a level lower than the forecast K 93 million.

Monetary policy for 1985 remains accommodative. The authorities believe that they can live with some overshoot of the targeted growth rate for private sector credit in 1985, particularly since it follows several years of relatively sluggish loan demand. As with 1984, moreover, there is a strong element of refinancing involved as a result of high interest rates in Australia and volatile currency movements. My authorities expect the pace of lending growth to slow in the second half of the year to prevent an excessive level of domestic demand from developing, which, if allowed to do so, could contribute to a significant deterioration in the balance of payments. As a first step toward this end, the central bank recently increased its own lending rates by 1 percent and announced a guideline limiting domestic refinancing of offshore loans. Other restrictive measures are still under consideration.

I should mention that my authorities have concluded talks with Australia on a new aid package. The agreements call for a total of A$1.4 billion (approximately US$1 billion) in aid over the next five years. Reduction in total aid will be gradual (3 percent per year in real terms) from the present flow of A$300 million per annum, with budget support declining by 5 percent a year in real terms. As the grant element is reduced, moreover, it is expected that aid in terms of funding for special projects will be increased. The developments I have described above have left the Government little room to maneuver on the fiscal front; these reinforce the need, indeed, to set priorities on expenditures under the medium-term development plan, which, along with the sectoral strategies underlying its formulation, will be tabled with the 1986 budget in November.

As if to give emphasis to the care with which they have assumed their somewhat expansionary stance, my authorities have established this year, under the guidance of some of the country's most experienced public servants and a World Bank consultant, a program monitoring unit to review and improve national and provincial departmental performance. Improvements in the review of activities and recurrent expenditure will help fund new development projects within the overall budget constraints. They have also initiated a major review of their planning process in order that draft strategies for the medium term may be prepared in the light of various scenarios under various assumptions.

In October of this year, the Minimum Wages Board is expected to begin deciding on the nature of the wages agreement to be in force over the next three years. My authorities believe that the high real wages in the formal sector have discouraged new job creation. They regard it as of paramount importance that the partial indexation arrangement in effect since 1983 be continued, if the country's competitiveness is to be improved, if the flexibility is to be increased with which policy can be implemented, and if more jobs are to be created.

On behalf of my authorities, I would like once again to thank management and staff for their continuing interest in the progress of Papua New Guinea's economy, especially in the midst of the adjustment it is currently undergoing. We look forward to hearing Executive Directors' views and advice.

Mr. Ismael endorsed the staff's conclusions regarding the economy of Papua New Guinea and the major issues facing it. The performance of the economy in 1984 had been satisfactory: real GDP had grown moderately, and there had been a marked improvement in the terms of trade; the inflation rate had declined to roughly half the rate in 1983, and external sector performance had also improved, with a significant decline in percentage terms in the external current account deficit. Moreover, the positive developments registered in 1984 were likely to continue into 1985: real GDP was expected to grow at a rate of 7.7 percent; inflation was projected to stay at roughly the same level as in 1984; and the external current account deficit was expected to decline further to about 10 percent of GDP. According to the staff, however, medium-term balance of payments prospects were not favorable, and the authorities were thus unduly optimistic about what might be accomplished on the balance of payments front. In his view, the staff assessment was a realistic one, and the authorities should be giving serious consideration to alternative policies that could change the course of events in future. There were at least four areas where corrective policies would be necessary.

There had been a worrisome slippage in the budgetary performance in 1985, and strong efforts would be required to bring the budget deficit to more sustainable levels, Mr. Ismael said. He agreed with the staff that the major contribution toward that objective must come from cutbacks in planned spending levels. In that regard, excessive spending and debt accumulation by the Government could prove to be a severe constraint on the implementation of the new development plan; hence, it was all the more important for the authorities to adopt appropriate financial policies aimed at preventing further deterioration in the deficit. Furthermore, the external debt situation could not be allowed to deteriorate further. The debt service ratio was expected to rise to more than 35 percent in 1988; and it was particularly important, therefore, for the authorities to exercise prudence in their expenditure and borrowing policies. He agreed with the staff that market sentiment could change quickly and that the authorities could face difficulties in arranging external financing from commercial sources.

The tightening of monetary policy was another corrective action that could be implemented, Mr. Ismael considered. Domestic bank credit had expanded by 21 percent in 1984, and by the first quarter of 1985, the rate of domestic credit expansion had increased further to 27 percent. Expansion at such a rate was certain to lead to a worsening of the external position, and he recommended early action to restrain domestic credit expansion. In addition, policy reforms might be necessary on the wages front. Because of the social and political implications of wage policy reform, the issue was a sensitive one for any government. However, it was widely appreciated that in highly open economies the practice of wage indexation reduced the usefulness of exchange rate policy as an instrument for improving export competitiveness. He hoped that in spite of the political constraints, the Government would provide leadership in bringing about further reductions in real wage costs.

Papua New Guinea's development needs were so great that without substantial foreign assistance their objectives would be difficult to achieve, Mr. Ismael observed. However, excessive reliance on such assistance placed the country in a vulnerable position. In 1984, nearly one third of total government expenditure had been financed from foreign grants, as had one third of the external deficit on the trade and services account. Those figures suggested that the Australian Government might be doing the right thing in fulfilling its intention gradually to reduce the level of grant assistance to Papua New Guinea. In the circumstances, it would be prudent for the authorities to pay greater attention to curbing government expenditure, improving revenue efforts, and making more effective use of available foreign aid. In conclusion, while pleased that the Papua New Guinea authorities had maintained a free and open exchange and trading system, he was worried that the medium-term outlook might make it difficult for the authorities to continue such an open system. It was partly for that reason that he felt the need to impress upon the authorities that adjustment was an urgent matter.

Mrs. Walker noted that the continuation by the Papua New Guinea authorities of effective adjustment policies, together with the favorable effects of external factors--particularly in the agricultural sector--had led the economy in 1984 to a peak in its recovery from the 1980 recession. Growth in real GDP had resumed, with a revival in demand in most of the economy; the terms of trade had increased by 10 percent; overall inflation had been reduced to 4 percent; and the authorities had continued their prudent policy of expenditure restraint, which had resulted in a better than expected reduction in the central government budget deficit and a strengthening of the external position, including a reduction in the planned amount of external borrowing.

While there had clearly been overall improvements in the economy of Papua New Guinea, data in SM/85/211 suggested that the underlying economy might not have fared as well, Mrs. Walker continued. For instance, overall inflation had dropped from 8.5 percent in 1983 to 4.4 percent in 1984, but that fall reflected mainly the increased availability of a key commodity. The underlying rate of inflation had remained at 6-7 percent, 3 percentage points above the inflation rate in partner countries and cause for concern. The improvement in the external sector, although assisted by a variety of factors, had been partially attained through a slowdown in overall import levels during 1984. However, beyond a reduction in imports for the OK Tedi mining project, general import demand had been quite strong in 1984. Furthermore, while the overall current account deficit had fallen by 2 percentage points to 13.5 percent of GDP in 1984, excluding OK Tedi related current transactions, the current account had worsened by 2.5 percentage points. Clearly, one could not base an assessment of Papua New Guinea's economy during 1984 only on developments in the underlying economy. However, the rather stark differences between results overall and results within specific sectors of the economy suggested that the economy was rather vulnerable and in her view would not be able to tolerate a relaxation of the prudent adjustment policies--particularly in the fiscal area--that the authorities had carefully pursued during 1983 and 1984.

It was possible that economic performance in 1985 might not be as favorable in all respects as had been the case during 1984; and the medium-term prospects could be considerably less positive, Mrs. Walker remarked. She could sympathize with the authorities' desire to take advantage of the positive economic climate at present to pursue more expansive policies designed to promote growth and employment. However, the authorities should be cautious about adopting policies that would reverse the hard-won gains of 1983 and 1984. In particular, the recent change in direction of fiscal policy was most discouraging. As Mr. Romuâldez had indicated, the authorities had taken measures to monitor spending in national and provincial departments, were committed to the continuation of the partial wage indexation agreement, and planned to make revisions in the budget where needed during quarterly reviews; however, they had little room for maneuver in the fiscal area. Spending must be kept on a sustainable path in order to limit the increase in public debt that had grown greatly in recent years and which, excluding OK Tedi debt, could exert pressure on the balance of payments. She agreed with the staff that urgent measures were needed to reduce the projected central government deficit in 1985 and that particular attention should be paid to holding down the Government's wage bill.

On the monetary side, the recent deregulation of commercial bank deposit rates was welcome, Mrs. Walker said, and she had taken note of the increase in interest rates recently announced by the central bank as well as the guideline limiting domestic refinancing of offshore loans. However, she agreed with the staff that the recent increase in credit expansion called for more restraining action.

Given the uncertainties in mineral prices and the abundant potential for agricultural growth in Papua New Guinea, she could support the authorities' intention to increase agriculture's contribution to economic growth and employment, Mrs. Walker observed. Price incentives, particularly the containment of domestic inflation aided by a welcome flexible exchange rate policy, should continue to increase profitability and production. Additional financial resources would be needed for the development of large-scale agricultural projects, and some government involvement would seem to be necessary to attract private investors. She would appreciate staff comment on what else could be done to attract more private investment in the agricultural sector and on what role the World Bank might play in that regard. Finally, it was to be hoped that the authorities in Papua New Guinea would follow the advice of the staff, particularly in the fiscal area, so that the positive achievements of 1984 could be repeated.

Mr. Robinson considered that the authorities should be commended for the good performance of the Papua New Guinea economy in 1984, a performance that in no small way reflected a prudent policy stance, notably in the fiscal area. It was encouraging in that regard to see that the recovery was projected to continue into 1985. Still, the return to expansionary policies in 1985 was disturbing, especially given the medium-term prospects. While some comfort might be drawn from the projected K 15 million in expenditure cuts noted by Mr. Romuâldez, the budget deficit was still expected to reach 4.7 percent of GDP, a level considerably higher than even the original estimate for 1984. With the prospect of a debt service ratio of 35 percent by 1988--four times the level in 1981--the authorities should be wary of further commercial borrowing, which implied the need for considerably tighter fiscal and monetary policies combined with measures to improve competitiveness.

The drop in tax revenue as a ratio to GDP projected for 1985 was due largely to a reduction in revenues from Bougainville Copper Ltd. (BCL), combined with some reduction in the kina value of external budgetary assistance, Mr. Robinson observed. Since revenues from the mineral sector were likely to remain weak, at least until the early 1990s, and the real value of external budgetary support would be declining continuously, the authorities would need to intensify their efforts to broaden the tax base.

Furthermore, he agreed with the staff's emphasis on the need to reduce real wages, Mr. Robinson said. However, under the current arrangements, wages were fully indexed when inflation was less than 5 percent. Real wage cuts could therefore be achieved under the present system only if inflation accelerated from its current level of 4.5 percent, which would clearly be an undesirable development. In the circumstances, he wondered whether, when the authorities came to renegotiate the current wages agreement for 1986 and beyond, and if a partial indexation system proved necessary, indexing wages to a fixed proportion rather than a fixed amount of inflation might not be more appropriate.

In addition, provided real wage cuts could be achieved, it would be important for the authorities to continue with a flexible exchange rate policy, Mr. Robinson said. Otherwise, commensurately stronger demand management measures would be needed. Given Papua New Guinea's heavy dependence on commodity exports and the need to foster and maintain the confidence of external creditors in the economy, the current high level of international reserves in Papua New Guinea was an important positive factor. It would be a pity if the advantage gained through the implementation of prudent economic policies in the past were to be eroded in future; hence, he urged the authorities at least to maintain their commitment not to allow reserves to fall below SDR 300 million. Finally, he would be interested in hearing answers to Mrs. Walker's questions on foreign direct investment.

Mr. Kobayashi welcomed the further improvement in economic performance in Papua New Guinea in 1984, with the growth rate having risen to 2.2 percent and inflation having declined to nearly 4 percent. Improvement in the terms of trade had been an important element in the strengthening of exports and the economic recovery; however, prudent economic management, centering on fiscal restraint, partial wage deindexation, and flexible exchange rate policies had also made a valuable contribution toward a better balance in the economy. Given the relatively comfortable level of external reserves, there seemed to be no major destabilizing factor in the short run, with the exception perhaps of rising unemployment among youth in urban areas.

Papua New Guinea's medium-term prospects were clouded by a number of uncertainties, Mr. Kobayashi continued. Prospects for open economies generally were sensitive to changes in terms of trade. It was unfortunate that uncertainties with respect to gold and copper prices had led to delays in the OK Tedi project, which took up an important share of overall economic activities. The external resource constraint made it difficult to significantly increase imports or fiscal spending in real terms. However, the average growth rate of 1.5 percent since 1975 was disappointingly low, given the population growth rate of more than 2 percent. As urban unemployment became a problem, the authorities would be faced with increasing pressure to raise the growth rate and expand employment opportunities. An important task of the authorities in those circumstances would be to consider how to achieve a higher growth together with a viable external position.

Remarking on specific aspects of economic policy in Papua New Guinea, Mr. Kobayashi observed that the 1983 wages agreement to limit wage indexation to the first 5 percent of consumer price inflation had opened new ground, breaking the direct link between the exchange rate, domestic prices, and wages. However, as the annual inflation rate had fallen below 5 percent thereafter, the agreement had become insufficient to restrain real wages in 1984 and 1985. In order to tackle the structural unemployment problem associated with high real wages, the authorities should adopt more flexible arrangements for the years to come. Like the staff, he believed that deregulation of wages for youth and for workers in rural areas would be an effective way of increasing employment opportunities. The staff had already pointed out the sensitive nature of the urban wage indexation problem in noting that deregulation of urban wages would be accompanied by increased industrial unrest. However, given the current level of nonagricultural wages--high by international standards--and the desirability of reducing the wage differentials between urban and rural areas, he wondered whether corrective measures might not be needed.

On fiscal policy, Mr. Kobayashi considered that the 1985 budget represented a departure from the cautious stance followed by the authorities since 1982. The authorities had shifted emphasis away from external adjustment toward growth and employment creation. While he could understand the pressure on the authorities to expand fiscal policy as unemployment became a serious social problem, he was concerned about the magnitude of the projected rise in the fiscal deficit, from 1.1 percent of GDP in 1984 to more than 5 percent in 1985. A similar expansionary stance had been adopted in 1980 and 1981 in the initial phase of the deterioration of the terms of trade, but it had had to be reversed in 1982 because of rising imbalances in the economy. Given that experience, he hoped that the authorities would re-examine their policy on spending, which should be contained within amounts dictated by the medium-term availability of budgetary and external resources. In that regard, continued efforts would be needed to contain growth in public sector employment and wages, and it would be important to set clear-cut priorities on expenditures under the medium-term development plan, as mentioned by Mr. Romuáldez. He welcomed the measures introduced in the current year's budget to increase revenue; but, in view of the need to maintain a reasonable rate of increase in development expenditure, the authorities should perhaps give further thought to widening the tax base through increases in indirect taxes.

With regard to the financing of the fiscal deficit, Mr. Kobayashi expressed regret that the authorities had been forced to abandon their initial goal of eliminating new foreign commercial borrowing by 1987. As a matter of fact, a substantial amount of commercial borrowing--from both domestic and foreign sources--would be needed to finance the deficit in the current year. As his chair had stated during the 1984 Article IV consultation, it would be desirable if the deficit could be contained at a level that could be covered by concessional borrowing and project-related borrowing from international agencies. He urged the authorities in the circumstances to make their best effort to reduce the share of commercial borrowing over the medium term. Finally, the authorities should step up their efforts to increase domestic resource mobilization, in view of the continued external resource constraints. The staff had indicated that the domestic savings rate had declined in 1984, despite further improvements in the terms of trade and the apparent rise in real interest rates that had come about with a decline in inflation. Perhaps interest rate policies could be used more actively to encourage savings over time. Although most interest rates had turned out to be positive in real terms in 1984, their level remained low by comparison with rates in many other countries. Also, there was perhaps scope for improving the institutional framework for mobilizing private savings by providing a wider range of financial instruments yielding a high rate of return.

The staff representative from the Asian Department observed that the authorities in Papua New Guinea had acted in recent years to eliminate a number of constraints that had been placed on investment in the agricultural sector and to ease the more general constraints on direct investment in the initial years following independence. As a result, the constraints were no longer a major impediment to foreign investment in agriculture. In recent years, the profitability of agriculture--especially in the plantation sector--had been a problem for many industries. The copra industry, in particular, had suffered badly, and it was interesting to see what had happened as a result of the improvement in the terms of trade over the past two years. It was instructive to note that a real surge had taken place in replanting in the plantation industries and that profitability was the key to that surge. In that respect, Papua New Guinea's main problem seemed to be one of competitiveness and of wage levels; and the authorities would do well to focus their attention on economic policy adjustments in those areas.

Among other impediments evident in the agricultural sector was the inadequacy of arrangements for the provision of capital and credit to small holders, who represented the future for agriculture in a country like Papua New Guinea, the staff representative continued. It was in recognition of those shortcomings that the authorities were planning to establish in 1985 the Agricultural Bank of Papua New Guinea. The World Bank and the Asian Development Bank were playing a role in funding the new agricultural bank.

The need for adjustment of wages in the urban sector had been mentioned by Mr. Kobayashi, the staff representative recalled. The staff felt that wages were clearly excessive throughout the economy, both in relation to labor productivity and to levels of wages in neighboring and competing countries; and the degree of excess was probably greatest in the urban sector. As a best-case solution, the staff would propose sweeping reforms throughout the economy to make wages responsive to underlying economic forces. Put another way, if the machinery were not already in place and accepted by the community, the staff would not encourage the authorities to adopt centralized wage procedures or any form of wage indexation; however, in tailoring its advice to individual countries, the staff must take account of accepted social norms and the general approach of the Government in managing the economy. In the case of Papua New Guinea, the staff understood that society generally, and particularly the more organized and vocal elements in urban areas, would have to accept the changes before they could be implemented; and the Government, in attempting to make wages conform to economic realities, must inevitably take into account the implicit social contract embodied in the established wages machinery. It was against that background that the staff had urged the Government to play a strong leadership role in promoting change in the general wage determination structure to make it responsive to economic forces and suitable to the economy's needs in the 1980s. The process would doubtless have to be gradual, but, unless it was initiated, the authorities would find it difficult ever to resolve the wages problem. As indicated by Mr. Romuáldez, the Government was thus far not attempting to push for major reforms in the new wages agreement; rather, it was aiming for a continuation of the existing framework broadly unchanged for the next three years.

Efforts should continue toward addressing those wage imbalances that most inhibited development and employment creation, the staff representative commented. There was little to be gained from insisting that the first line of attack should be toward substantially reducing urban wages; such an approach seemed certain to generate the greatest resistance and held the greatest potential for creating industrial unrest. Moreover, even if substantial adjustment were achieved, wages would still remain excessive, and the likelihood of creating a large number of new jobs in the urban sector seemed remote. Hence, the staff had encouraged the authorities to focus attention on areas where the acceptance of change was likely to be greater, where the imbalances were smaller, and where the greatest potential for job creation existed. By freeing rural wages from minimum wage laws, the authorities would introduce flexibility in agriculture--in both the plantation sector and among small holders--where the greatest potential gains for growth in employment might be expected. Similarly, by introducing a lower youth wage, the authorities might encourage absorption of young people into the work force, easing the urban youth unemployment problem and perhaps promoting more flexibility in urban wages at large. While those approaches were not in themselves likely to resolve the problem of excess wages within the framework that the Government had established, they should nevertheless be sufficient to generate a gradual movement that could lead in time to substantial positive adjustment.

The point had been made by Mr. Robinson that the current arrangement made it imperative for the authorities to ensure that inflation was in excess of 5 percent if any reduction in real wage levels was to occur, the staff representative recalled. That issue had been discussed with the authorities, and a number of options had been recommended. In passing, he noted that the option put forward by Mr. Robinson was not one that the staff had discussed with the authorities, but it could well be incorporated into an agreement that the authorities might wish to consider. One option the staff had suggested was, for example, indexing only for inflation above a certain threshold, an approach that would ensure a more rapid adjustment in real wages when inflation was low. Another possibility was to reduce the threshold amount, thus compensating wage earners for, say, the first 2 percent of inflation, which would allow the authorities in a situation of a 5 percent inflation rate, to adjust to a 3 percent reduction per year in real wage levels.

Mr. Romuáldez noted that the authorities in Papua New Guinea had recently established a medium-term development strategy aimed at dealing with precisely the problems pointed out by Directors, principally the recent shift in fiscal policy and the problem of wages. The thrust of the strategy was away from increased government spending and toward the establishment of cuts in current expenditures and embodied as well a movement toward greater private sector responsibility in investment. The authorities hoped that the plan would lead to increased savings in the public sector that would enable the funding of more important development projects. In those areas where investment priorities were being established, the aim was to ensure more productive investments that could be brought on stream quickly. In general, the authorities in Papua New Guinea were well aware of the extent of the current external debt and debt servicing problems, and they were determined to avoid foreign commercial borrowing as much as possible by mobilizing savings and cutting expenditures while seeking more concessional funding, especially from multilateral institutions.

With regard to the problem of wages, the Government's position had been clearly outlined by the staff, Mr. Romuáldez continued. The authorities, who were at present preparing for the October meetings of the Minimum Wages Board, felt that wages in Papua New Guinea were excessive, and they were determined to make adjustments and to play the leadership role called for by the staff to bring about changes in the wage system. The authorities were aware that the inflation rate in Papua New Guinea was at present lower than 5 percent, and they felt that the level of inflation would be a helpful element in the forthcoming discussions on wages because it would provide them with a greater measure of credibility and some leverage in seeking further concessions regarding indexation.

The Acting Chairman made the following summing up:

> Executive Directors concurred with the appraisal in the staff report for the 1985 Article IV consultation with Papua New Guinea and noted that economic developments during 1984 were generally favorable, in part reflecting the benefits from improved external demand, in particular for agricultural exports. Directors noted that these positive developments were buttressed by policies supporting external adjustment and, in particular, by the continued firm fiscal policies pursued during 1984. The authorities were commended for having taken advantage of the period of external strength to reduce the level of outstanding official foreign debt on commercial terms.

While economic developments in 1985 promised to remain reasonably satisfactory, Directors observed that prospects beyond 1985 were less favorable, despite the boost to the economy expected from the start up of operations at the OK Tedi mine. In their view, the likelihood of weakness in export prices, together with the setback to the plans for the further development of the mine and the recently announced agreement to reduce Australian assistance make it necessary for the authorities to strengthen the stance of economic policies in several areas from the course set in the current year.

Directors noted that the 1985 budget departed significantly from the path of fiscal restraint followed since 1982. Indeed, developments subsequent to its preparation indicate that the 1985 budget will be even more expansionary than planned unless action is taken promptly. In this connection, Directors welcomed the recent decision of the authorities to reduce government spending in 1985 below the budgeted amount, but they were of the view that further adjustment measures were needed to substantially reduce the prospective budget deficit in 1985. It was essential to put government finances again on a sustainable path, consistent with external viability over the medium term. While measures to broaden the tax base should be pursued, including possible adoption of indirect taxes, a large part of the adjustment would fall on the expenditure side. A return to lower fiscal deficits would facilitate a reduction in the level of official external borrowing on commercial terms from the excessive amounts currently planned for 1985 and beyond. In view of the sharp rise in debt service payments projected over the next few years, Directors urged the authorities to exercise extreme prudence in debt management and to considerably scale back planned official commercial borrowing.

A number of Directors noted that monetary policy had been too relaxed throughout 1984, and that a large expansion in private credit had led to rapid monetary growth and a building momentum of domestic demand. In view of the weakening external position and the continuing strength of demand, Directors welcomed the reduced credit expansion and slowing of monetary growth implied by the official monetary policy for 1985. However, they observed that private credit had continued to expand rapidly in the first half of 1985 and they urged that restraining measures be adopted to ensure that the objectives of the 1985 monetary policy are achieved.

Directors considered that efforts to address several structural problems were needed if the authorities were to be able to effectively pursue their development objectives and reduce persistently high unemployment. In that connection, they said, the authorities must reduce excessive wage costs and strengthen the international competitiveness of traded goods industries over the medium term. It was observed that some progress toward that end had been made over the past two years as real wages had been reduced slightly. Over the same period, the kina had depreciated modestly in real effective terms, and the authorities were advised to follow a flexible exchange rate policy with the aim of strengthening competitiveness. Directors encouraged the Government to play a strong leadership role in support of increased flexibility in wage determination and, in that connection, they questioned the current method of indexing wages.

Finally, Directors observed that, while Papua New Guinea needs foreign assistance for its economic development, it should avoid becoming overly dependent on that external source of savings. That, in turn, underscored the need for a decisive strengthening of domestic financial policies and resource mobilization. Directors commended the authorities for Papua New Guinea's prudent reserve policy and encouraged them, if anything, to increase reserves. They also encouraged the authorities to improve the environment for foreign direct investment.

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

APPROVED: May 6, 1986

LEO VAN HOUTVEN
Secretary

The program of energy policy reform recommended to the Government by the Bank, two years previously, had covered a period of ten years, the staff representative from the World Bank recalled. That period of price adjustment was essentially a matter of judgment. The judgment of the Government and the World Bank was that bringing domestic energy prices into line with international prices would call for significant adjustment accompanied by a large investment in conservation methods and in industrial processes. It would be counterproductive to move too quickly without allowing time for the industrial sector, which was currently the major consumer of energy, to make that adjustment.

The Executive Directors agreed to resume 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/85/121 (8/5/85) and EBM/85/122 (8/7/85).

2. ECUADOR - EXCHANGE SYSTEM

The approval under Executive Board Decision No. 7927-(85/39), adopted March 11, 1985, for the retention by Ecuador of the multiple currency practice arising from the multiple rate system, the exchange restrictions involved in the minimum financing or barter requirement for imports, and the exchange restriction corresponding to external payments arrears is extended until the completion of the 1985 Article IV consultation with Ecuador or September 30, 1985, whichever is earlier. (EBD/85/202, 8/1/85)

Decision No. 8043-(85/122), adopted
August 6, 1985

3. MEXICO - TECHNICAL ASSISTANCE

In response to a request from the Mexican authorities for technical assistance to undertake a comprehensive survey of the direct taxes levied by the Federal Government, the Executive Board approves the proposal set forth in EBD/85/200 (7/31/85).

Adopted August 6, 1985

4. JOINT COMMITTEE ON REMUNERATION OF EXECUTIVE DIRECTORS - GOVERNORS' VOTE

The Executive Board approves the report of the Secretary (EBAP/85/154, Sup. 2, 8/5/85) on the canvass of votes of the Governors on Resolution No. 40-1, with respect to remuneration of Executive Directors and their Alternates, approved by the Executive Board (EBM/85/99, 6/21/85) for submission to the Board of Governors. The Governors' vote on the Resolution is recorded as follows:

Total affirmative votes		434,361
Total negative votes		237,496
Total votes cast		671,857
Abstentions recorded	183,312	
Other replies	1,641	
Total replies		856,810
Votes of members that did not reply		73,208
Total votes of members		930,018

Decision No. 8044-(85/122), adopted
August 5, 1985

5. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 84/160 and 84/161 are approved. (EBD/85/199, 7/30/85)

Adopted August 5, 1985

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and Advisors to Executive Directors as set forth in EBAP/85/204 (8/2/85) and by an Assistant to Executive Director as set forth in EBAP/85/206 (8/2/85) is approved.

APPROVED: May 6, 1986

LEO VAN HOUTVEN
Secretary