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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/148

10:00 a.m., September 23, 1985

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

Executive Directors	Alternate Executive Directors
	L. K. Doe, Temporary
C. H. Dallara	M. K. Bush
J. de Groote	
	S. de Forges
	C. Flamant, Temporary
M. Finaish	
	M. Sugita
G. Grosche	B. Goos
J. E. Ismael	
	G. D. Hodgson, Temporary
A. Kafka	
T. P. Lankester	T. A. Clark
H. Lundstrom	
	A. Abdallah
F. L. Nebbia	J. J. Dreizzen, Temporary
	E. M. Ainley, Temporary
	S. Geadah, Temporary
P. Pérez	G. Ortiz
J. J. Polak	J. de Beaufort Wijnholds
C. R. Rye	
G. Salehkhou	O. Kabbaj
	A. Vasudevan, Temporary
	L. Tornetta, Temporary
Zhang Z.	Jiang H.

J. W. Lang, Jr., Acting Secretary
B. J. Owen, Assistant

Also Present

IBRD: M. Palein, Western Africa Regional Office. African Department: A. D. Ouattara, Director; A. Bourhane, E. A. Calamitsis, S. E. Cronquist, A. Jbili, O. Kaba, B. R. H. S. Rajcoomar. European Department: L. A. Whittome, Counsellor and Director; P. Alonso-Gamo, L. M. Beleza, H. B. Junz, A. Leipold, A. López-Claros, D. C. L. Nellor, T. M. Ter-Minassian. Exchange and Trade Relations Department: C. D. Finch, Counsellor and Director; W. A. Beveridge, Deputy Director; M. Guitián, Deputy Director; J. T. Boorman, E. H. Brau, S. Kanesa-Thasan, N. Kirmani. External Relations Department: A. F. Mohammed, Director; H. P. G. Handy. Fiscal Affairs Department: M. I. Blejer, L. M. Ebrill. Legal Department: G. P. Nicoletopoulos, Director; Ph. Lachman. Research Department: W. C. Hood, Economic Counsellor and Director. Secretary's Department: A. Wright, Deputy Secretary. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; P. D. Brenner, J. Jaramillo-Vallejo, C. G. Muniz B. Bureau of Statistics: F. B. Muller. Personal Assistants to the Managing Director: R. M. G. Brown, S. P. Collins. Advisors to Executive Directors: D. Hammann, S. M. Hassan, J.-C. Obame, G. W. K. Pickering, M. Z. M. Qureshi, A. Steinberg, E. M. Taha, D. C. Templeman, N. Toé. Assistants to Executive Directors: J. R. N. Almeida, Bo T., M. B. Chatah, A. K. Diaby, R. Fox, O. Isleifsson, S. King, S. Kolb, M. Lundsager, R. Msadek, K. Murakami, A. H. Mustafa, D. J. Robinson, J. E. Rodríguez, M. Sarenac, A. J. Tregilgas, E. L. Walker.

1. GROUP OF FIVE - ANNOUNCEMENT OF MINISTERS OF FINANCE AND CENTRAL BANK GOVERNORS

Mr. Dallara referred to the announcement made the previous afternoon by the ministers of finance and central bank governors of France, Germany, Japan, the United Kingdom, and the United States, following their meeting in New York. The ministers and governors had met as part of their continuing effort to assess the international economic situation and to conduct mutual surveillance of their economic performance and policies. Each of those countries--with others--had declared their commitment at the Bonn summit meeting to sustain noninflationary growth and higher employment. At their meeting in New York, the ministers and governors had reviewed the progress made by their countries toward a favorable convergence of economic performance and policies and had agreed that their economies were experiencing a more balanced expansion. Further, they felt that their countries were on the right policy path, having implemented macroeconomic policies designed to strengthen competitive forces and free up resources for the private sector and having worked to deregulate capital markets and reduce structural rigidities.

The large and rising U.S. current account deficits and the large and rising surpluses in Japan, and to a lesser extent in Germany, had also been a focus of the discussion, Mr. Dallara reported. In that connection, there was great concern about rising protectionist measures, with the ministers and governors firmly agreeing that a turn toward protectionism would be very dangerous for the world economy and that it was essential to resist pressures to introduce restrictive trade measures. Indeed, the ministers and governors had collectively affirmed a commitment to avoid protectionist measures, and each one had also made a separate commitment to that effect.

Each country had also agreed to make specific additional commitments relating to future policies that would strengthen further their efforts to achieve strong noninflationary growth, Mr. Dallara added. A number of those specific policy intentions were outlined in attachments to the Announcement of the Ministers of Finance and Central Bank Governors (EBD/85/246, 9/23/85). Taken together, the ministers and governors believed that those measures should promote greater convergence in economic performance toward noninflationary growth, thereby contributing to a strengthening of nondollar currencies. They also felt that the meeting represented a positive effort to address concerns about large trade and current account imbalances among the countries involved and that the meeting demonstrated a positive result of cooperation and consultation among major industrial countries.

Mr. Grosche remarked that the meeting had been particularly helpful at the present time in conveying the impression that protectionism was growing and that everything should be done to fight it. His authorities had reconfirmed the intention of the German Government to continue to pursue policies already adopted with a view to sustaining and extending the progress achieved so far.

Mr. Lankester remarked that the meeting had been very useful and had demonstrated an extraordinary degree of agreement between the finance ministers and central bank governors. It was important, first, that the five countries had restated their determination to pursue policies that would lead to a more convergent economic performance and more convergent policies, a point that had been made in the discussion of the world economic outlook. Second, each of the five countries had made a strong statement on the need to resist protectionist pressures. Third, all parties had agreed that the recent shifts in economic conditions had not been fully reflected in exchange rates and that an orderly appreciation of nondollar currencies would be helpful. In that connection, the five countries had stated that they would be taking action in certain circumstances to assist that readjustment in exchange rates.

The present and proposed policy stance of his authorities was indicated in a statement attached to the announcement, Mr. Lankester remarked. Together with the statements made on behalf of the other countries represented, the announcement and the meeting itself had set a helpful precedent for continuing agreement on policies in the months ahead.

Mr. de Forges said that his authorities fully agreed with the announcement made on the previous day, especially on the need for convergence in economic policies and adequate exchange rates.

Mr. Sugita considered that the meeting had been particularly important in having taken up explicitly the exchange rate problem at a time when protectionist pressures were growing.

The Chairman observed that the meeting did indeed represent an important move toward greater cooperation and stronger positions on resistance to protectionism, the promotion of convergence of economic performance and policies, and a more orderly management of the exchange rate system based, he ventured to say, more on the economic fundamentals. The outcome of the meeting would be followed up with great interest.

2. MEXICO - REPORT BY MANAGING DIRECTOR

The Chairman informed Executive Directors that following the tragic earthquake in Mexico, he had immediately conveyed a message of condolence to the Governor of the Fund for Mexico. At the same time, he had pondered the desirability of doing more than offer words of sympathy and had considered the possibility of Mexico's making use of the Fund's resources under the policy on providing emergency assistance to members that experienced natural catastrophes. After consultation with the staff, he had dispatched a cable to the President of the Mexican Republic on September 20, 1985, which read as follows:

> I wish to express to you my deep sorrow for the loss of life and destruction that resulted from yesterday's earthquake. Please be assured that we stand ready to assist your country to the

fullest of our ability to do so. We are able in certain circumstances to provide emergency assistance to members afflicted by natural disasters. To examine this possibility I am prepared to send a personal representative for discussions with your officials as soon as you deem feasible.

He had been deeply dismayed, the Chairman added, to read in the Washington Post of September 20, 1985--the very same day that the Mexican earthquake was front page news--an uninformed and ill-timed article referring to problems that Mexico had been having with its Fund-supported program, information that had been public knowledge six weeks previously. What had disturbed him was the resuscitation and misreporting of old news juxtaposed with the account of the catastrophe. In order to correct the impression that had been created by that misleading article, which reported that the Fund had taken "a decision to cut off" Mexico from access to its resources under its extended arrangement, an official press release had been issued (Press Release No. 85/30, 9/20/85) indicating that the Fund's procedures did not involve a decision to cut off members' access to resources but explaining that countries were not able to make drawings as long as they were out of compliance with the terms of an arrangement. The relationship between the Fund and its members, and in the present instance between Mexico and the Fund, was following its normal course and was, in fact, a close and harmonious one. Such ill-conceived press reports were all the more frustrating when the Fund subsequently had great difficulty in having the truth fully reported.

Mr. Ortiz said that he shared the view that such press reports benefited nobody. They had been ill received in Mexico, where despite present limited contacts with Mexico City, the article had been published on the same day in the Monterey newspapers, to general consternation.

He felt sure that his authorities would appreciate the offer of the Fund's assistance, Mr. Ortiz added. He also wished to take the opportunity to thank the governments of various countries which had generously offered help.

3. CENTRAL AFRICAN REPUBLIC - 1985 ARTICLE IV CONSULTATION AND STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1985 Article IV consultation with the Central African Republic, together with a proposed decision concluding the 1985 Article XIV consultation, and a request from the Central African Republic for a stand-by arrangement in an amount equivalent to SDR 15 million (EBS/85/204, 8/27/85). They also had before them a report on recent economic developments in the Central African Republic (SM/85/259, 9/9/85).

Mr. Doe made the following statement:

The economy of the Central African Republic has evolved satisfactorily in many respects in 1984. Total output growth resumed, inflationary pressures declined substantially, the budget deficit also decreased markedly, and the external position improved. This progress, achieved under a Fund-supported stabilization program, is expected to be furthered under another program for which the Government of the Central African Republic is also requesting Fund assistance.

Following a sharp drop in total output in 1983 by 7 percent on account of severe drought, real GDP recovered in 1984, growing by more than 8 percent. The interplay of better weather conditions, higher producer prices, and extension services contributed to this resumption of economic expansion. Growth was noticeable not only with respect to cash crops--in particular, coffee and cotton, but also for food crops--cassava, groundnuts and millet/sorghum. Production was effectively stimulated by higher producer prices set for both cash and foodcrops. In this regard, the unit prices for cotton and coffee were increased by 13 percent and 11 percent, respectively, for the 1984/85 season. Likewise, the producer prices for millet/sorghum and groundnuts were raised by 50 percent and 22 percent, respectively. These increases generally exceeded the rate of inflation. In addition, it must be noted that the actual prices received by farmers mirrored market conditions and were generally higher than the official prices, in particular for coffee, as buyers competed for the limited output. Furthermore, production incentives were buttressed by improved extension services and supply of insecticides and fertilizers. The upward movement in consumer prices decelerated sharply from 15 percent in 1983 to less than 3 percent in 1984, largely owing to the improved supply of food crops.

In the fiscal sector, the budget deficit, commitment basis, decreased by the equivalent of 2 percentage points in 1984, representing only 1.3 percent of GDP. This performance reflected the combined effects of higher tax revenue and lower expenditure. In particular, the restrictive employment policy, together with the restraint exercised on the remuneration of government workers, contributed to the decrease of the nominal wage bill. Expenditure on materials and supplies was also sharply reduced in 1984. The reduction in these expenditures is in striking contrast with the substantial increase in interest payments. Revenue measures enacted in 1984 included an increase in taxes on petroleum products and exports. The income tax structure was also streamlined. Both domestic and external arrears were reduced substantially.

In the external sector, despite significantly improved earnings from cotton and diamond exports, growth in export receipts were subdued--7 percent--reflecting the decrease in coffee exports due to the adverse impact of the 1983 severe drought on supplies. This sluggish expansion of exports was more than offset by higher impors, essentially for re-export purposes. These developments, together with lower inflows of grants, led to a small deterioration in the current account deficit in absolute terms, although as a ratio to GDP, it declined. On the whole, thanks to the improved capital account position, the overall balance of payments recorded a surplus in 1984, a reversal of the deficits of the last two years.

As a continuation of the efforts leading to these achievements, the Government initiated a new 18-month program, the macroeconomic objective of which include a reduction of the budget deficit to near equilibrium in 1986 and a further narrowing of the external current account deficit. The realization of these objectives is predicated in particular upon the continuation of normal climatic conditions, the policy changes enacted earlier, and foreign financial and technical support. In the real sector, the integrated rural development projects for cotton and food crops, and coffee--jointly financed by the Government, the IDA, and other foreign creditors--is being implemented as planned. The focus of these projects remains an improvement in the production of these crops through increased productivity. The supply of extension services and inputs will continue to be ameliorated, as will be the marketing and distribution facilities. Cotton production in 1985/86 is to be further stimulated by higher producer prices.

Regarding government finances, attention and efforts will be concentrated on enhancing revenue performance. To this end, the authorities of the Central African Republic have requested Fund assistance. In the meantime, several departments of the tax administration apparatus will be reorganized and strengthened. In particular, the units in charge of auditing tax returns, assessing tax liabilities, and collecting these taxes will be reinforced. Efforts to collect tax arrears will be stepped up. Government expenditure restraint has been considerable in the Central African Republic during the past few years, and it would be unrealistic to expect further reductions in outlays. As an indication of the extent of the reduction in real wages, it should suffice to state that no general wage increase has been granted to government workers since 1980 while the CPI has risen substantially over the same period. The authorities of the Central African Republic are nevertheless maintaining their stance on spending restraint.

In the external sector, a moderate expansion of exports is forecast to arise in 1985 from increased coffee sales essentially,

following the return of normal weather in 1984. However, the overall balance of payments position is projected to weaken slightly owing to the higher outflows on account of imports and service payments, notably interest payments. Steps to improve the feeder road network and general transportation in cotton farming areas are expected to encourage cultivation and marketing of this crop, thus leading to the recovery of export earnings in 1986. This development, together with increased earnings from diamond exports, could give an impetus to export receipts and contribute to a further decrease of the current account deficit.

In sum, important progress has been achieved in 1984 toward stabilizing the finances of the country and laying the foundations for a sustainable noninflationary growth and development. The authorities of the Central African Republic intend to carry further the improvements registered thus far and are seeking to this end the continued cooperation of bilateral foreign aid donors and creditors as well as of international financial institutions such as the Fund.

Mr. Flamant noted that the staff report provided ample evidence that several years of painful adjustment efforts were at last starting to pay off. The difficulties experienced in 1983 because of the drought might have led to an underestimation of the magnitude of those efforts. But the return to normal weather conditions in 1984 had been quick, as in Côte d'Ivoire, to bring about a turnaround in economic performance which would not have been possible in the absence of sound policies geared to restraining demand and to boosting production.

The proposed program covered the remaining part of 1985, the whole of 1986, and the first three months of 1987, and built on the results already achieved, Mr. Flamant added. In passing, he noted that a 15-month program might have been more appropriate since the fiscal year in the Central African Republic was the same as the calendar year. In the same vein, the low level of annual access of 32.9 percent of quota--possibly one of the lowest so far on an annual basis--did not appear to be in line with the magnitude of the adjustment effort. Moreover, as the staff well knew from its experience with other African countries that were members of currency unions, balance of payments need could not be assessed on the basis of reserves only, as had nevertheless been done in the staff appraisal. The extent of the balance of payments need could be determined easily from its request for further debt relief through a Paris Club rescheduling. He had also been a little puzzled not so much by the number of drawings--seven--as by the heavy backloading of those purchases. He would find it helpful to have staff comment on whether or not those technical features of the arrangement were in keeping with the guidelines laid down by the Executive Board.

Referring to the substance of the program, Mr. Flamant said that he had noted with satisfaction that the estimates for 1985 and the projections for 1986 pointed to a further reduction of the budget deficit on a cash basis. Like the staff, however, he was worried that that outcome would be achieved more by continuous restraint on expenditures than by the buoyancy of tax revenues. The very low elasticity of the tax system was indeed a matter of concern, and he urged the authorities to move ahead resolutely to implement measures aimed at improving tax collection. The request to the Fund for technical assistance in that area showed that it had decided to tackle the problem, which boded well for the future.

On the expenditure side, the reduction of current outlays seemed to have gone as far as it could, Mr. Flamant remarked. A further reduction might reduce the efficiency of the administrative system. As far as investment expenditures were concerned, he concurred with the staff in recognizing that the investment budget should include foreign financed investment, although that was never easy to do, in particular because of the difficulty of obtaining all the necessary information from external donors as to the pace of disbursements. The Central African Republic might need technical assistance in that respect as well; perhaps it could be provided through the second technical assistance project approved by the World Bank in April 1985. However, it was more important for the World Bank to be closely involved in the design and monitoring of the investment program, which seemed to be adequately tailored to the development strategy of the country, with a strong emphasis on rural and agricultural development.

Supply-side policies rightly represented a major component of the program, Mr. Flamant said, and the results of the authorities' efforts of the past two years had not been long to materialize. Producer prices in the coffee sector were now fixed at levels that seemed to provide sufficient incentives to producers; the increase in the price of cotton had led to a spectacular increase in production, although at CFAF 100 per kilo, there might still be some room for further increases. The price of food crops was determined mostly by market forces, which seemed to be the best way to arrive at the right set of relative prices.

Structural reform also seemed to be well under way in the public enterprise sector, Mr. Flamant remarked. The Government had taken a number of measures aimed at improving the management of state enterprises, privatizing some of them or closing down those that could not be rehabilitated.

All in all, Mr. Flamant concluded, the Central African Republic was on the right track. The continued pursuit of the sound policies that were being implemented should permit the attainment of sustainable growth with a viable balance of payments position in the near future.

Mr. Geadah said that he was in broad agreement with the staff analysis and conclusions and that he supported the proposed decisions. Substantial progress had been achieved by the Central African Republic in the context of

its stabilization program supported by the Fund. The policies pursued, helped by a return to normal weather conditions, had reversed the decline in output and improved the fiscal and external positions. However, a sustainable external position had not yet been attained. Balance of payments deficits persisted, and significant debt service obligations loomed in the period ahead. Accordingly, a continuation of the adjustment effort was needed. The proposed program was strong and comprehensive; if implemented fully, it should consolidate the gains achieved and maintain the adjustment momentum.

The authorities' overall strategy was rightly directed toward promoting the private sector, Mr. Geadah continued. However, if the expansion of the private sector was to be accommodated without an unwarranted increase in prices, further improvement in the fiscal position was essential. A strengthening of that position was also essential to eliminate the outstanding arrears on official external payments obligations, without which continued donor and creditor support was likely to be impaired.

Since reductions in public expenditures might be increasingly difficult to implement in the future, as the staff had argued, the authorities should concentrate their attention on improving revenue performance, Mr. Geadah continued. The collection of taxes was in particular need of strengthening, as tax revenues were forecast to decline as a percentage of GDP in 1985. In that context, he asked the staff about the present status of the Central African Republic request for Fund technical assistance.

The plans to rehabilitate the parastatal sector with World Bank assistance were welcome, Mr. Geadah remarked. Many public enterprises were in need of restructuring to make them economically viable. With respect to the 1985 investment program, it was vital that projects should be based on sound cost calculations and realistic marketing analysis. Therefore, the apprehension of the World Bank about the feasibility of some of the agro-industrial projects included in that program was a cause for concern.

With respect to monetary and credit policies, the increase in credit programmed for 1985 and 1986 was considerably greater than in earlier years, Mr. Geadah observed. The staff had cited a projected improvement in economic activity to justify the rate of growth of credit, which, it suggested, should be kept under close review to avoid an excessive increase in liquidity and inflation. He had noted that the rate of inflation was projected to increase sharply in 1985.

Ms. Bush observed that the Central African Republic's request for a new stand-by arrangement followed the successful completion of the program supported by the previous arrangement. The measures included in the new adjustment program should further enhance producer incentives together with a continuing reduction in the fiscal sector deficit, an appropriate mix in her view. The medium-term outlook indicated that balance of payments

viability was attainable within a few years, although the current account deficits projected for 1985 and 1986 were still somewhat on the high side. Some of that concern was, however, alleviated by the apparent availability of adequate financing on concessional terms.

The most important features of the adjustment effort were related to the orientation toward producer incentives, Ms. Bush considered. Producer prices for cotton and for other export and food crops had been raised again following the good response to producer price increases in 1984. While similar increases in output might not be possible for all crops in 1985 because of lower rainfall, it was encouraging that the authorities appeared to be firmly committed to adjusting prices as needed to stimulate supply. With the favorable medium-term outlook hinging on sustained export growth, adequate price adjustments in future must also be forthcoming. Also, as her chair had noted during the reviews of the previous program, the reduction in the export tax on diamonds had been most welcome, bringing as it did an increase in exports through official channels. According to Mr. Doe's statement, earnings from diamond and cotton exports had also improved. She asked on which products the export tax had been increased in 1984 and how diamonds and cotton exports had fared subsequently.

The reforms of the public enterprises seemed to be enhancing the efficiency of production in the Central African Republic, Ms. Bush said. The rehabilitation of the public enterprise sector included privatization--in part or in full--of firms whose output could be more efficiently produced by the private sector. The authorities were also committed to the liquidation of enterprises unable to become profitable. One striking aspect of the reform that was particularly appropriate was the encouragement of small- and medium-sized firms in the manufacturing and handicraft sectors. The private sector could be particularly productive in that area. Given the World Bank's assistance in the rehabilitation effort, comments by the staff member from the World Bank on the progress being made would be helpful.

The fiscal effort appeared to be progressing well, with the deficit on a cash basis--taking into account the elimination of arrears--being programmed to fall to under 1 percent of GDP in 1985 and 1986 as well, Ms. Bush noted. Such fiscal responsibility was gratifying. Personnel expenditures would continue to be contained, and the strict recruitment policy in effect should lead to a long-term reduction in personnel costs. The improvement in revenue collection was also appropriate, given that revenue and expenditure were both at around 12 percent of GDP, excluding foreign financed investments.

With respect to the investment budget, it appeared desirable to increase capital expenditures since the fiscal deficit had been brought largely under control, Ms. Bush continued. Some 90 percent of such spending was being financed by external grants and concessional loans, and the stand-by arrangement included a performance criterion prohibiting new external debt on commercial terms. Nonetheless, with some projects

being likely to take several years to complete, she urged the authorities to ensure that there was adequate financing to complete the projects. Furthermore, the authorities needed to be aware of the budgetary implications of the cost of maintaining new facilities and institutions in the future, especially as the staff had reported the authorities' belief that they had limited scope for reducing current outlays in real terms in future. Her concern in that respect arose from the mention in the staff report of some reservations on the part of the World Bank about certain agro-industrial projects, especially the sugar and palm oil projects; the authorities should consider carefully the Bank's advice in that area. She also supported the staff recommendation that the budget include foreign financed investment, which would be of assistance in case additional costs were incurred.

On monetary policy, the interest in providing adequate credit to the growing private sector was gratifying, Ms. Bush remarked. Interest rates in real terms were expected to fall below zero in 1985, owing to the large increase expected in the rate of inflation--up to 8.5 percent as a result of the lower production of food crops. She had noted the authorities' view that inadequate financial institutions had a greater impact on savings than the interest rate. Nonetheless, she wondered whether savings might not increase in response to higher rates on small deposits. With growing farm profitability, rural savings might also perhaps increase. Additional incentives were clearly required to increase the low gross domestic savings rate of 2.5-3 percent of GDP.

The medium-term outlook indicated that the Central African Republic could achieve a sustainable balance of payments position within a few years, Ms. Bush concluded. Even 1986 did not appear likely to be too difficult a year, although a budgetary gap was projected, indicating a need for debt rescheduling. On the assumption that some debt relief would be forthcoming and in the expectation that the authorities could take compensating measures if that relief was less than expected, she could support the proposed decisions. She also approved of the size of the stand-by arrangement.

Mr. Goos said that he too had been glad to note that the Central African Republic had made further progress under the previous adjustment program. The combination of prudent fiscal policy and supply-oriented measures appeared to have brought the country closer to achieving the target of a sustainable balance of payments position. Continued adherence to such a broad policy approach, combined with a further reduction of arrears, should enhance the confidence of creditors and donors upon whose continued support the Central African Republic was critically dependent. He had noted in that respect that the Paris Club was expected to reschedule maturities that had been rescheduled previously. It was worth mentioning that such an arrangement would represent a departure from more or less firmly established rules of the Paris Club, indicating a particular gesture of goodwill.

Referring to the program under discussion, Mr. Goos said that he particularly welcomed the expected elimination of arrears and the emphasis on further fiscal adjustment. The major issues relating to fiscal strategy had been covered adequately in the staff report, and Mr. Doe had appropriately stated that "attention and efforts will be concentrated on enhancing revenue performance." However, he wished to make two comments. First, on monetary policy, he had found the staff comment that most interest rates on deposits were at present negative in real terms to be difficult to reconcile with the stated primary concern of the monetary authorities to encourage investment in agriculture and other productive sectors. Negative real interest rates would fail to mobilize the required resources. Moreover, a policy of letting interest rates on deposits above a certain limit be determined by market forces while interest rates on deposits below that limit were kept artificially low might have adverse distributional effects. Therefore, he joined Ms. Bush in encouraging the authorities to strive, if possible, for positive real interest rates while at the same time improving the banking structure in order to enhance the mobilization of financial savings. The authorities' concern with investment could and should be met more efficiently, especially in an overall economic context, by emphasizing structural measures related to producer prices, costs, the supply of inputs, and marketing arrangements.

The balance of payments, at the moment when the proposed stand-by arrangement was about to be approved, was recording a sizable gap for 1985 and for 1986 as well, albeit a smaller one. The staff had offered the assurance that on the basis of preliminary consultations with major creditors and donors, sufficient external support for the balance of payments as well as for the budget was expected to be forthcoming. While he had no particular difficulty with that expectation, he attached great importance to the intention to reach understandings with the authorities on additional adjustment measures that might become necessary to cover any remaining financing gap. Furthermore, in the circumstances, the staff had been right to arrange for a considerable degree of back loading in the schedule of drawings under the stand-by arrangement. In conclusion, he endorsed the staff appraisal and supported the proposed decisions.

Mr. Finaish commented that the Central African Republic had made some encouraging progress in its pursuit of adjustment in the past few years. Its record in implementing the 1984 program had been particularly good. The adjustment measures taken were contributing to a reduction of domestic and external financial imbalances as well as to improvements on the supply side of the economy. The proposed program for 1985-86 would help in sustaining the ongoing process of adjustment, and the broad range of demand management and structural policies in the program should help to move the economy further toward the objective of a restoration of sustainable growth with external financial viability. Therefore, he could support the proposed stand-by arrangement.

The staff had noted in its appraisal that further adjustment toward a sustainable external position would be increasingly dependent upon successful implementation of policies aimed at increasing output, Mr. Finaish

continued. That emphasis on linking adjustment to the expansion of the productive base was well placed, although expectations about future growth had to be tempered by the projection that the average GDP growth rate in the period up to 1990 would not exceed 3 percent, which would be only marginally higher than the rate of population growth. Raising the rate of output growth consistent with the envisaged path to balance of payments viability would require, among other things, raising the domestic savings rate so as to finance a higher rate of investment. Currently, over 85 percent of investment was financed from external grants and concessional loans. According to Appendix Table I of the report on recent economic developments, the domestic savings rate had ranged from -3.2-3 percent of GDP since 1981. While external assistance needed to be maintained at an adequate level, an important element of the medium-term economic strategy should be to enlarge the flow of investable resources through a gradual increase in the domestic savings rate. In that connection, it would be helpful if the staff could indicate whether its medium-term balance of payments projections and the investment levels envisaged in the development plan for 1986-90 implied any increase in the domestic savings rate.

Measures included in the program--namely, the further strengthening of the fiscal position and the reform of public enterprises--should contribute to increased savings in the public sector, Mr. Finaish added. However, action was also necessary to raise savings in the private sector if the overall savings rate was to rise significantly. An adequate return on financial savings would be essential, as would the promotion of real investment opportunities in the private sector. Most interest rates on deposits continued to be negative in real terms, and private sector investment remained a rather small proportion of total domestic investment.

The authorities were reported to be of the view that the difficulties in mobilizing financial savings were attributable to the inadequacy of the existing banking structure rather than to the level of interest rates, Mr. Finaish observed. It would be useful to learn from the staff whether any measures were being taken or contemplated to deal with that inadequacy.

Recognizing that further reductions in public expenditures might be increasingly difficult to achieve, the staff had noted that vigorous action was needed to increase budgetary revenues, Mr. Finaish said. In that respect, the authorities proposed to improve tax collection, but the question was whether that would suffice to generate the needed increase in revenues and whether some new tax measures might not be needed in addition.

The level of access proposed, of 32.9 percent of quota on an annual basis, appeared to be the lowest rate of annual access so far for a program in the upper credit tranches under the enlarged access policy, Mr. Finaish observed. Some further elaboration by the staff of how it had determined the amount of access under the proposed stand-by arrangement, in light of the criteria for access in individual cases, would be helpful.

The staff representative from the African Department noted that the authorities had requested that the 1984 stand-by arrangement, which had expired in July 1985, be succeeded immediately by a new arrangement. Although the proposed arrangement would cover an 18-month period from end-September 1985 to end-March 1987, the program period covered the two calendar years 1985 and 1986, so that the budget year was fully covered.

As Directors had observed, the revenue increase foreseen for 1985 and 1986 would be of crucial importance to the budget outturn, the staff representative added. In its discussions with the authorities, the staff had underlined the efforts that would need to be made to restore the buoyancy of tax receipts--in particular, by improving tax collection. The authorities had requested Fund technical assistance and a staff mission from the Fiscal Affairs Department was expected to be in Bangui within a few months; it would seem essential that the mission take place before the review under the stand-by arrangement, foreseen for January 1986, when the 1986 budget would be discussed. The most recent changes in the tax system had been made in 1984; none were foreseen for 1985 and 1986. Although tax rates had not been increased in 1984, the standard values used for taxation of certain exports had been increased--for instance, on ivory, cigarettes, and certain minor exports.

As a member of a currency union, the Central African Republic was not in a position to raise interest rates unilaterally, the staff representative remarked. Deposit rates had been positive in 1984 when the inflation rate was low but had become negative in 1985.

The inflation rate in the Central African Republic was mainly affected by the domestic crop situation, the staff representative continued. Based on the new retail price index, consumer prices had risen at a much lower rate in 1984 because of a bumper food crop. In 1985, the rate should be lower than in 1982 and 1983 but not as low as in 1984 since the lack of rain in the first half of the year had affected the crops.

The domestic savings rate in terms of GDP was still low, although it had been increasing in 1983 and 1984; the staff projected a continued increase during the period of the program, the staff representative from the African Department added. An increase in domestic savings would be particularly important because of the need to increase the locally financed part of investment over the medium term. Only about 10 percent of the investment program had been financed domestically in recent years, and the authorities aimed at increasing the share of domestic financing.

Mr. Goos observed that the point was repeatedly made in discussions on countries that belonged to monetary unions that there was virtually no possibility for them to influence interest rates. Yet he had taken note of a statement on page 23 of EBS/85/204, reporting the view of the authorities that "some flexibility had been introduced since 1983 in that interest rates on time deposits of more than CFAF 10 million are freely determined by the banks." He had understood therefore that the common central bank did not impose interest rates and that the member countries

had the option of fixing rates on deposits up to a certain amount, with rates above that amount being determined freely in the market. There would thus appear to be some room to make interest rates more flexible, as both he and Ms. Bush had suggested.

The staff representative from the African Department responded that the scope for flexibility was limited to large deposits by institutional investors; deposit rates for small savers were fixed by the common central bank. To the best of his knowledge, there were no plans to increase further the element of flexibility that had been introduced in the interest rate structure. It was a matter for the monetary union, and the staff raised the issue with the common central bank whenever it held consultation discussions with countries of the Central African Monetary Area.

Mr. Flamant considered that the role of interest rates should not be overemphasized in a country that was still at a very early stage of monetization. As he understood it, there was only one local branch of the banking system outside of Bangui so that an increase in interest rates would not have much effect on financial savings.

The staff representative from the African Department noted that the commercial banking system was in fact structurally inadequate because it did not extend beyond the capital city, with the exception of one agent. However, the absence of commercial banks in the countryside was to some extent compensated for by the post office savings bank, which was a channel for smaller, local savings deposits.

The Deputy Director of the Exchange and Trade Relations Department said that the proposed period of the stand-by arrangement--18 months--reflected a variety of factors. The program would extend through calendar 1986, and it was important to have a last test date as of the end of December 1986. However, the data would not be available until the first months of 1987. If there were to be a Fund-supported program in 1987, which was not a matter for consideration at present, compliance with performance criteria for the end of 1986 under the stand-by arrangement would be an important consideration.

The extent of a member's access to the Fund's resources depended on many factors, the Deputy Director remarked, including the strength of the country's adjustment effort, which was unquestioned in the case of the Central African Republic, but also on balance of payments need. As mentioned in the staff report, the Central African Republic had had reserves at the end of 1984 equivalent to about four months of imports. Moreover, as Table 6 in EBS/85/204 showed, purchases from the Fund in 1985 and 1986 would be about CFAF 10 billion, compared with a balance of payments deficit for those two years of CFAF 1.5 billion. Thus, the Fund was making a significant contribution to financing not only the overall balance of payments deficit but to the repayment of cash payments arrears of around CFAF 3 billion. It would have been very difficult to justify higher access for the Central African Republic. It was also necessary to

be mindful that the Central African Republic's obligations to the Fund, which accounted in 1984 for 32 percent of total debt service, were forecast to increase slightly before falling to an average 26 percent of total debt service in the period 1988-90. The Fund should certainly not allow itself to become a major part of a member's debt problem.

It was normal for purchases under a stand-by arrangement to be back loaded when the budget for the forthcoming year was still to be discussed in detail, the Deputy Director from the Exchange and Trade Relations Department explained. Moreover, the budget financing gap for 1986 had not yet been closed. The staff had had to make some unusual assumptions relating to debt relief in order to close the financing gap, which in the Central African Republic was a budgetary rather than a balance of payments problem. It might have been possible to ask the Executive Board to approve the stand-by arrangement in principle, pending the outcome of the forthcoming Paris Club meeting. However, because the Executive Board preferred to make sparing use of the procedure for approval in principle and because contacts with the Paris Club had led the staff to believe that it was not unreasonable to make those assumptions for 1986, the better course had seemed to be to ask the Executive Board to approve rather small early purchases and to call for an early, additional review, which was at present scheduled for October. If the Paris Club did not agree to the unusual rescheduling of debt that had already been rescheduled, the implications were obvious; as the Secretariat of the Paris Club had made quite plain to creditors, if debt rescheduling on the scale envisaged was not approved, it would be necessary for the authorities to take additional and early fiscal action.

Mr. Flamant asked whether there was in fact a trade-off between Fund financing and debt relief, and if so, whether the use of Fund resources was more costly than debt rescheduling, or vice versa.

The Deputy Director of the Exchange and Trade Relations Department commented that neither debt rescheduling nor the use of Fund resources were inexpensive. It was not appropriate to consider debt rescheduling through the Paris Club and use of the Fund resources as being substitutable. He reiterated that the budgetary gap and the need for an unusual degree of debt rescheduling would occur not so much in 1985 as in 1986, when the gap would be quite sizable, in the absence of debt rescheduling. The matter would then become one not of borrowing additional resources from the Fund but of taking additional fiscal action.

The staff representative from the World Bank remarked that the successful first efforts of the Government of the Central African Republic would continue to be supported by the World Bank, which however considered that the formulation of sectoral investment strategies, programs, and economic planning policies should be speeded up. Those were the considerations at the center of the current dialogue between the World Bank and the Government of the Central African Republic, and they were also the rationale of the second technical assistance project that had

just become effective, as well as being an additional reason for the World Bank's support of the preparations for the United Nation Development Program (UNDP) Round Table, scheduled for 1986. Improved public investment programming based on appropriate sector strategies and application of strict economic criteria in selecting public investment projects formed the cornerstone of the technical assistance project.

Significant addititional work needed to be undertaken on the reform of public enterprises, the staff representative explained. Another member of the technical assistance team would be dealing with that sector, in the hope that some reforms would ensue, possibly with the assistance of the World Bank.

For the future growth of the economy, it seemed essential that the Central African Republic finance a higher proportion of its public investment, the staff representative stated.

Finally, the staff representative from the World Bank noted, a World Bank mission dealing with the agricultural sector had recently returned and was preparing its report. It might be possible to identify additional policies in the agricultural sector in order to help formulate a package of further reforms for discussions with the Central African Republic authorities, possibly for support by the World Bank.

Mr. Doe remarked that it was correct to note that interest rates and the extent of the network of banking services would influence savings in the Central African Republic. But it should also be noted that as the fiscal situation improved, with an increase in revenue and continued restraint in government spending, public savings should become available to help boost the overall savings ratio. Similarly, if economic activity remained buoyant over time, the income of the private sector should grow and eventually help increase the savings ratio.

In attempting to attract savings from those earning smaller incomes, as well as from the large public enterprises, Mr. Doe added, it was possible that the banking system might have a tendency to look for larger deposits in an attempt to lower costs and increase returns. The various costs associated with handling small savings deposits might prevent the banking sector from earning a sufficiently high rate of return to pay higher interest rates on such savings deposits.

In conclusion, Mr. Doe said, he would convey to his authorities the comments of Executive Directors in support of the various measures and policies that had been implemented, together with the concern they had expressed about the future course of action in the Central African Republic.

The Chairman made the following summing up:

> Executive Directors generally agreed with the views expressed in the staff appraisal. They noted with satisfaction the successful implementation of the 1984 economic and financial program

which had helped to reduce the financial imbalance and to provide propitious conditions for a resumption of economic growth. In particular, Directors commended the authorities of the Central African Republic for their efforts to improve the budgetary situation through a restrained recruitment policy, a continued freeze on wages and salaries, and a reduction in arrears. However, concern was expressed about the unsatisfactory revenue performance.

Directors welcomed the measures taken to rehabilitate the public and mixed enterprises and the further steps taken to introduce the pricing of their goods and services on the basis of cost consideration. They also pointed to the beneficial impact of the flexible producer pricing policies on production and exports, particularly cotton.

Directors also noted with satisfaction that the authorities were determined to pursue their adjustment efforts and that the economic and financial program for 1985-86 was geared toward achieving the medium-term objective of reducing the external current account deficit to a sustainable level by 1988. In this regard they stressed that policy initiatives to stimulate investment and production would assume increasing importance. Thus, they welcomed the authorities' continued emphasis on appropriate incentive policies, including the further increase in real terms of the producer price for cotton. They further encouraged the authorities to pursue, with World Bank assistance, the restructuring of the state and mixed enterprises so as to make them financially viable.

With regard to fiscal policy, Directors underscored the need for a continuation of a tight policy stance in order to attain the target of fiscal balance by 1986-87, particularly as revenue performance so far had not been in line with expectations. Directors agreed, therefore, that there was a need to strengthen tax collection and noted that Fund technical assistance had been requested for this purpose. On the expenditure side the authorities were encouraged to continue their efforts to reduce the public civil service. It was also pointed out that the assistance of the World Bank would be of help in directing investment toward priority items.

As to credit policy, Directors noted that the anticipated expansion in total domestic credit in 1985 reflected an increase in credit to the private sector for financing crops and exceptional imports of petroleum products. Directors nonetheless urged the authorities to review with caution the expansion of domestic credit. As most interest rates on deposits remained negative in real terms, several Directors encouraged the authorities to introduce a positive interest rate policy to improve

the mobilization of financial savings. It was essential, indeed, for the future sustained growth of the economy to enhance the mobilization of domestic savings and increase their share in the financing of investment.

On the external side, Directors welcomed the authorities' decision to eliminate outstanding debt arrears in 1985. In view of the projected budgetary and external financing gaps in 1985 and 1986, it was hoped that creditors and donors would provide additional assistance to the Central African Republic, including appropriate debt relief to support the authorities' adjustment efforts.

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

The Executive Board then took the following decisions:

Decision Concluding Article XIV Consultation

1. The Fund takes this decision in concluding the 1985 Article XIV consultation with the Central African Republic, in the light of the 1985 Article IV consultation with the Central African Republic conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes with satisfaction that the Central African Republic continues to maintain an exchange system that is free of restrictions on payments and transfers for current international transactions.

Decision No. 8092-(85/148), adopted
September 23, 1985

Stand-By Arrangement

1. The Government of the Central African Republic has requested a stand-by arrangement for a period of 18 months from September 23, 1985 through March 22, 1987, in an amount equivalent to SDR 15.0 million.

2. The Fund approves the stand-by arrangement set forth in EBS/85/204, Supplement 2.

3. The Fund waives the limitation in Article V, Section 3(b)(iii).

Decision No. 8093-(85/148), adopted
September 23, 1985

4. SPAIN - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Spain, together with a proposed decision including the 1985 Article XIV consultation (SM/85/248, 8/27/85; and Cor. 1, 9/20/85). They also had before them a report on recent economic developments in Spain (SM/85/254, 9/9/85; and Cor. 1, 9/20/85).

Mr. Pérez made the following statement:

My authorities are in general agreement with the analysis and assessment presented by the staff. Hence, I shall limit my comments to highlight the broad economic policy guidelines followed by the Government and to provide some information on economic developments that have taken place since the time of the consultation.

General economic strategy

When the socialist Government came to power in December 1982, the economic situation in Spain was characterized by deep macroeconomic disequilibria and structural problems. During the early 1980s, economic growth stagnated; inflation remained at very high levels; unemployment increased; the external current account recorded significant disequilibria; and the public sector deficit grew at exponential rates. As a result of these trends, Spain accumulated a significant external debt burden.

The sharp economic deterioration reflected an adverse cyclical international situation and, above all, deep structural problems stemming from the delay in coping with the consequences of the two oil shocks.

The new Government was fully aware that attempts to boost the economy through expansionary fiscal and monetary policies could induce short-lived positive effects in growth and employment, but only at the risk of further jeopardizing the possibilities of a solid and more permanent economic recovery. Accordingly, in the framework of a medium-term plan, the Government designed an economic strategy geared at reducing the macroeconomic imbalances through tight fiscal and monetary policies;

a restrictive wage policy; and a realistic exchange rate policy. Along with the macroeconomic measures, my authorities began implementing policies directed at strengthening the supply capacity of the economy by eliminating rigidities; restraining the public sector's absorption of resources; promoting competition; and adapting relative prices in accordance with the resource endowment of the country.

The perseverance of the authorities on their economic strategy has already borne some fruit, as shown by the following figures:

	1981	1982	1983	1984
GDP (percentage changes year to year)	0.4	0.9	2.5	2.3
Inflation (CPI) Dec./Dec.	14.4	14.0	12.2	9.0
Overall government deficit (as percentage of GDP)	3.0	5.3	5.3	4.8
External current account (as percentage of GDP)	-2.6	-2.3	-1.7	1.3
Gross national saving (as percentage of GDP)	18.2	17.6	18.0	20.5

These results show improvement but are far from being satisfactory in the light of the severe unemployment situation.

For 1985, economic prospects point to a GDP growth rate of about 2 percent; to a further reduction in the rate of inflation (between 1 and 1 1/2 percentage points); to a reduction in the public sector borrowing requirements despite the tax cut approved by the Government last April; and to a surplus in the current account of the balance of payments, of roughly the same amount as the one registered in 1984.

Recent developments

The economic policy applied in 1984 attained significant results in the correction of the macroeconomic imbalances faced by the Spanish economy. Monetary discipline and the reduction in both the public sector deficit and labor costs led to a decrease in the rate of inflation, an easing of interest rates, an improvement in the profitability of enterprises, and a dramatic turnaround in the external current account. Nevertheless, these positive results were not accompanied by a reactivation of internal demand--namely, private investment--nor an improvement in the employment situation.

For 1985, the Government's principal objective is to consolidate the basis for a new phase of sustainable economic growth and employment. In this regard, the main economic targets are to bring down the rate of inflation through monetary control and further decrease in labor costs, and to provide more room for maneuver to the private sector through a reduction in the size of the public sector. At the same time, the authorities are attacking the main rigidities of the economy by reducing the scope of the public enterprises; by taking a wide range of measures in order to enhance the flexibility of the labor markets; by reforming the social security system, thus preventing the deepening of financial imbalances and contributing to decreasing the unit labor cost in the medium run; and by fostering the modernization and competitiveness of the industrial sector.

Since the staff report was written, significant changes have occurred in monetary developments as well as in the performance of investment, prices, and unemployment.

Monetary policy

At the end of 1984, the Spanish economy was recording a deceleration in the rate of inflation and a considerable surplus in the overall balance of payments. In addition, some economic indicators were pointing to an incipient recovery of domestic demand. In this context, the monetary policy was directed to maintaining the declining trend of inflation without jeopardizing the possibility of a modest recovery. To this end, the growth of liquid assets in the hands of the public (ALP) was targeted within a band of 11.5-14.5 percent, while M3 growth was to be maintained between 9.5-12.5 percent.

A temporary acceleration of the inflation rate associated with poor performance in some agricultural crops during the first part of the year, and monetary developments related to the approval of the new fiscal treatment of financial assets, led the monetary aggregates to move outside the upper limits of their target band. During the first quarter of 1985, ALP increased approximately 16.9 percent on an annual basis, while M3 was growing at a rate of 10.8 percent, still within the targeted band. However, during the second quarter, both ALP and M3 exceeded the upper limits of the target zone with rates of increase of 17.5 percent and 13.2 percent, respectively. In the face of these events, the monetary authority reacted promptly by applying a more restrictive monetary policy. This led in turn to upward pressures on domestic interest rates, reversing the trend followed since the last part of 1984. Between March and June, interbank lending rates moved from 12 percent to 13.9 percent. As a result of this more stringent monetary policy and

of a sharp drop in the public sector borrowing requirements in July and August, both ALP and M3 decelerated to annual rates of 13.8 percent and 7.3 percent, respectively, at the end of August, returning ALP growth to the central target and placing M3 growth well below target. As a consequence of these developments, interest rates have again declined, resuming the trend observed during the first part of the year. At this point, the Banco de España foresees a rate of growth of 13.5 percent in ALP for the year as a whole, fully compatible with the projected GDP growth of 2 percent and an inflation rate of 7.5-8.0 percent through the year.

Fiscal policy

As no additional positive impact stemming from the external sector is foreseen in 1985, after the strong real growth recorded in 1984, the Government's economic strategy for 1985 aims at stimulating a moderate expansion of domestic demand through cuts in direct taxes, at the same time allowing interest rates to reflect developments abroad. In this context, the public sector deficit was programmed to reach the same level registered in 1984 in nominal terms, notwithstanding that income tax withholding rates were reduced in an amount equivalent to 0.5 percentage point of GDP. This strategy involves a further reduction in expenditures, mainly in transfer payments. Recent information on public sector performance points to the accomplishment of the targeted public sector deficit.

External sector

After the remarkable export performance recorded in 1984, the authorities' main target for 1985 is to consolidate the gains already made. As mentioned by the staff, 1984 was an extraordinary year for the Spanish external sector. Exports grew 17 percent in real terms, and a surplus was reached in both current and capital accounts, leading net official reserves to a rise of $4.6 billion.

The lack of dynamism in world trade, as well as increasing protectionist tendencies abroad have led exports to register a deceleration during the first semester of 1985. Conversely, imports have been growing at a rate of 4 percent due to the reactivation of investment. Nothwithstanding these shifts in the flows of trade volume, the improvement in the terms of trade stemming from the drop in the dollar exchange rate and oil prices and the maintenance of Spain's export prices, may result in an estimated current account surplus of $2 billion, a figure similar to the outcome corresponding to 1984.

Regarding the capital account, the more comfortable external financial position of the country, as well as an easing in domestic interest rates have fostered an early amortization of external debt. During the period January-June 1985, a deficit of $520 million was recorded compared with a surplus of $3 billion in the same period in 1984. Despite this early amortization, Spain maintains a comfortable level of international reserves of about $10 billion. The exchange rate of the peseta, after the devaluation that took place in December 1982, recorded an appreciation in real terms during 1983 and 1984, losing most of the earlier gains. However, since the second quarter of 1985, the peseta has depreciated gradually in real terms along the trend followed by the inflation differential between Spain and its main trading partners.

In sum, during 1984 and 1985, Spain has solved its external disequilibrium allowing the country to face access to the EEC with a relatively sound external position.

Investment

Preliminary information for the first half of the year indicate that investment is growing at a rate of 4-5 percent on average for the year as a whole. These growth estimates are based on the strong recovery observed in the demand for capital goods. Domestic production of capital goods has increased 7 percent in real terms during the first six months, and the behavior of sale orders suggests that this recovery will be maintained. In addition, spurred by government construction and housing starts, the construction industry seems to be picking up during the second half of the year after a long period of prolonged deterioration.

Prices

The acceleration of the inflation rate that took place at the beginning of 1985 has abated. In July the CPI increase reached 7.9 percent through the year. As mentioned above, the price level behavior at the beginning of the year was substantially affected by the sharp rise in the food component. The crops of several agricultural products that have an important weight in the CPI were irreversibly affected by extremely unfavorable weather conditions. Nevertheless, the rise in the price of nonfood components of the index that gives a better indication of the underlying price behavior has maintained a declining trend all along. With the normalization of food prices that has occurred since June, Banco de España foresees an inflation rate of 7.5-8.0 percent by December 1985. This positive outcome should contribute to a further lowering of inflationary expectations, a crucial factor that may in turn help to narrow inflation differentials with other European

countries, despite the possible impact on prices stemming from the introduction of the value-added tax in 1986, a measure associated with Spain's entry in the EEC.

Unemployment

The most worrisome feature of the Spanish economy is the high level of unemployment that has placed Spain ahead of the rest of OECD countries in this undesirable ranking. There are a number of factors at the base of this social and economic problem. The inadequacy of our capital stock in relation to our endowment of productive factors; the wage behavior during the 1970s; the rigidities of the labor market; and the return of expatriates from European countries during the last ten years are some of the main factors explaining the unemployment situation in Spain. As mentioned by the staff in this and past consultations, the Government has coped with this problem by adjusting relative prices; restoring enterprises' profitability; decreasing labor costs--both through the decrease in wages in real terms and the reduction in social security contributions--and eliminating rigidities in the labor market as well as in the economy as a whole. Some of the measures already adopted include the introduction of short-term and part-time contracts; the reform of the social security system; the liberalization of opening hours in the retail sector; and the elimination of rent controls. While all of the above measures are essential for long-term employment growth, their contribution to improve the present difficult situation will only be gradually felt. In the light of the current world economic prospects, the Spanish Government believes that, in addition to the above measures that will have a full impact in the medium term, a set of timely supply incentives are needed to improve the employment picture in a relatively short time horizon. In this regard, a set of marginal employment subsidies were approved early this year.

As a result of the sustained economic policy thus far, the elimination of rigidities and the effects of the package of marginal incentives, employment has started to increase. For the first time in several years, employment in nonagricultural sectors grew by 73,000 new jobs in the second quarter of 1985, and unemployment has been steadily decreasing during the past five months. It is too early to draw any definite conclusions and a longer period of observation appears to be necessary. Nevertheless, this positive outcome is encouraging and my authorities are now even more convinced that the current policy stance must be maintained.

Mr. Nebbia said that he was pleased to note that the policies being followed by the Government of Spain were yielding the expected results. It was most encouraging to observe that as in 1984, the Spanish economy

had exhibited a great ability to meet the majority of the Government's short-term targets while being subjected at the same time to the process of deep structural reform launched to deal with the rigidities embedded in the economy, thereby enhancing the prospects for growth and stability in the years ahead.

Referring first to the achievements in the external sector, Mr. Nebbia said that he had been impressed by the shift in the balance on current account from a deficit of more than $2.7 billion in 1983 to a surplus of more than $2 billion in 1984, representing close to 3 percent of GDP. That outturn was all the more notable because it followed a trend that had begun soon after 1981 when the deficit on current account had reached a peak of almost $5 billion. It was apparently expected that the improvement would be maintained through 1985, although as the staff had indicated, the overall flexibility and competitive position of the Spanish economy would be tested with Spain's entrance into the European Communities on January 1, 1986. By the same token, the overall balance of payments position had improved. Reserve losses of $3.3 billion and $0.3 billion in 1982 and 1983, respectively, had given way to a surplus of the order of $4.5 billion at the end of 1984, fostering an early amortization of external debt.

He fully agreed with both the staff and the authorities that the performance of the external sector in 1984 had been extraordinary, Mr. Nebbia added. Exports had increased 17 percent in real terms as a consequence of the strong growth of foreign demand, depressed domestic demand, and improved competitiveness following the real depreciation of the peseta in 1982 and 1983. Consolidation of the gains already made should remain the authorities' major objective for 1985. He had been glad to learn from Mr. Perez's statement that the improvement in Spain's terms of trade in 1985 would almost offset the downward shift in the volume of trade flows during the first half of the year.

As for price developments, the deceleration in inflation that had begun in 1983 had been sustained throughout 1984, Mr. Nebbia observed, with the consumer price index recording an increase of slightly over 11 percent for the whole year and just under 9 percent from December to December. As noted by the staff, it was the first time in several years that the rate of inflation had been reduced to a one-digit figure; even more important, inflationary expectations seemed to have abated significantly as indicated by the fall in nominal interest rates and in the wages negotiated during 1984. A reduction in inflationary expectations would remain crucial to a further reduction of inflation and, as Mr. Pérez had stated, might help also in narrowing inflation differentials with other European countries, in spite of the possibility that the introduction of the value-added tax in 1986, associated with Spain's entrance into the European Communities, might have an impact on prices.

With respect to fiscal policy, Mr. Nebbia remarked that the Government's borrowing requirement had fallen relative to GDP for the first time in many years, from 7 percent in 1983 to 6.4 percent in 1984.

That result was in line with the objective for the year although it had been achieved at higher than expected levels of both revenue and expenditure. The outcome for 1984 was a positive indication that in spite of the fact that the structure of the deficit had not improved as desired, the reduction of the deficit itself had effectively reversed the persistent trend on the part of the public sector to absorb private sector savings, a necessary although not a sufficient, condition for the recovery of private productive investment.

The improvement in the public sector's financial situation had been based largely on revenue increases, particularly more efficient tax collection as well as a broader tax base, Mr. Nebbia continued. He recalled that when the Executive Board had discussed the staff report for the 1984 Article IV consultation with Spain (EBM/84/126, 8/10/84), Directors had emphasized that the thrust of budgetary policy should be on controlling expenditures rather than on increasing revenues. Two crucial areas had been identified in that respect: the social security system and the public enterprises, both of which needed to be set on a self-sustaining course, inter alia, by avoiding the gamut of special incentives, subsidies, and other forms of budgetary support. The rationalization of the financial position of public enterprises had begun to show results but was still far from leading to a substantial reduction of budgetary transfers. Indeed, while the operational losses of some enterprises appeared to have been stabilized, the impact on budgetary flows had been offset by an increase in budgetary transfers to strengthen the balance sheets of other public enterprises to enhance their appeal to the private sector in the context of the Government's privatization strategy. With respect to the reform of the social security system, the recently passed pension law represented an appropriate movement toward the rationalization of the system and should lead progressively to a reduction of budgetary transfers needed for its operation. In practical terms, the benefits would at least be on a scale that the economy could afford and abuses within the system should be eliminated.

The unemployment situation was the most worrisome feature of the Spanish economic situation, Mr. Nebbia considered. A number of causes underlay the current high rate of unemployment in Spain--namely, the inadequacy of the capital stock in relation to other factors of production; the behavior of wages in the 1970s; the return of expatriates from other countries in Europe in the past ten years; and finally, the rigidities of the labor market, which, in fact, compounded the effects of the other causes.

There were three major factors behind the failure of labor market conditions to improve, Mr. Nebbia agreed with the staff. First, the balance sheets of enterprises were still weak, despite the recent improvement in profits, indicating that the ground had not yet been prepared for the resumption of productive investment on a large scale. Second, enterprises faced structural problems in managing the labor force flexibly owing to the high costs of shedding labor, the rigidity of the

wage structure, and the high social security contributions that employers had to make. Third, and perhaps the most important factor, was the need to observe a specific sectoral wage agreement. In sum, regenerating job opportunities would require both structural changes in the labor market, as well as the continuation of general wage moderation.

It took longer for structural changes to yield the expected results, Mr. Nebbia added. Large-scale investment would be possible only after a significant strengthening of the balance sheets of enterprises and a moderation of labor costs. The latter could be achieved in part through a broad reduction in employers' social security contributions, but would nevertheless need to be accompanied by a commensurate increase in savings that would require enterprises to adapt other measures, the need for which was not always promptly recognized. Therefore, it remained essential that a moderating influence be exerted on wage policy; in that respect, he would welcome further information on the probable consequences for the employment situation of the recently approved scheme of wage indexation. Although structural changes in the labor market and continued wage moderation would contribute to an increase in employment in the medium term and long term, more immediate action was needed to accelerate an improvement of the severe unemployment situation in Spain. In that respect, the recent cuts in the social security contribution rates for particular segments of the labor force were particularly appropriate.

In conclusion, Mr. Nebbia asked Mr. Pérez to convey to his authorities in Madrid his chair's acknowledgment of the major efforts made by the Spanish authorities to deal with various structural rigidities in the economy. By following the example of Spain, other industrial nations could bring benefits to their domestic economies while at the same time making an important contribution to global economic welfare.

Mr. Ismael said that he was in general agreement with the staff appraisal and that he could support the proposed decisions. The Spanish authorities had successfully laid the groundwork for economic adjustment and a return to sustainable high growth rates. Most of the Government's targets for the year had been achieved. Gross domestic product had risen by 2 1/4 percent in 1984 as projected. The rate of inflation, which had begun to decline in 1983, had been further reduced in 1984, to 9 percent, the first one-digit rate of inflation achieved in many years. Real wages had fallen significantly, again for the first time, as a result of a policy of wage restraint. The current account remained in substantial surplus. The public sector deficit had declined, and the Government's borrowing requirement had fallen from 7.2 percent of GDP in 1983 to 6.4 percent in 1984, above the target.

Nevertheless, the central policy objective of the Government, to improve the unemployment situation, had not been achieved, Mr. Ismael remarked. Structural rigidities in the labor market remained the major impediment to an increase in the demand for labor. The overall unemployment rate had increased during the year to more than 20 percent,

one of the highest rates of industrial countries. Moreover, difficulties in containing the fiscal deficit confronted the authorities with a formidable task. If those imbalances were not to hamper the country's long-term economic progress, more needed to be done and in a more determined way.

Referring to fiscal policy, Mr. Ismael noted that the authorities were to be commended for successfully implementing measures to increase revenue by broadening the tax base and curtailing tax evasion. The result had been a steady increase in tax revenue without increases in tax rates, which, in turn, had made possible a tax cut in 1985 that the authorities intended to make permanent in 1986. Those developments were especially noteworthy, considering that the incidence of tax was heavily concentrated on wage earners. Nevertheless, a successful policy for raising fiscal revenue could not be a substitute for a cut in public expenditures if effective control was to be maintained over the share of resources absorbed by the public sector. In that connection, the authorities' efforts to rationalize the pension system and to contain the losses to public enterprises were appropriate. However, more vigorous efforts were needed, in particular to raise the low social security contributions of employees and to contain the mounting burden of loss-making public enterprises. The authorities' resistance to pressure from unions and employers alike to weaken the pension reform was encouraging. Equally encouraging was their commitment not to accept any demand on the Government's budgetary resources of any public enterprise that had been sold to the private sector. With that in mind, he urged the authorities to press forward with the privatization of the public enterprises.

The monetary program for 1985 appeared to be consistent with the current targets for real economic growth, Mr. Ismael commented. However, as the staff had rightly suggested, it was essential that the authorities stay within the monetary targets, even at the cost of reversing a considerable part of the decline in interest rates that had taken place in 1984. Low inflationary expectations and a steady financial policy weighed more heavily in the investment decisions of the private sector than a temporary rise in interest rates.

Certain policy measures had been taken by the authorities to ease structural rigidities in the labor market, which continued to be severe, Mr. Ismael noted, but the authorities would have to take further action if they were to achieve their central objective of increasing employment opportunities. In that connection, he had been encouraged by the unions' acceptance of declines in real wages, which would be essential if structural rigidities in the labor market were to be eased.

Spain's continued remarkable export performance was due to a favorable external climate as well as to improved external competitiveness following the depreciation of the peseta in 1982/83, Mr. Ismael observed. However, as the staff had pointed out, the gains in external competitiveness had begun to erode. Furthermore, Spain's entry into the EC in 1986

would test the economy's ability to adjust with flexibility to changes in the competitive environment. A flexible exchange rate policy was clearly needed if the authorities were to stop the erosion of competitiveness stemming from the appreciation of the exchange rate. Over the medium term, however, policies to dismantle the increasingly complex systems of special incentives and regulations would have to be instituted if the Spanish economy was to remain competitive.

Finally, Mr. Ismael noted with regret that Spain's official development assistance had declined substantially since 1982, especially in light of the large current account surplus recorded in 1984 and expected for 1985 as well. It was his hope that the Spanish authorities would take advantage of their improved financial situation to increase Spain's future contributions to ODA.

Mr. Wijnholds remarked that the 1985 Article IV consultation with Spain came at a momentous point in the modern history of the country, which was within a few months of becoming a full member of the European Communities, with all the benefits that that would entail. Thus, Spain was entering a new and hopeful era although there were risks as well as major benefits potentially involved in fuller economic integration in Europe. He felt sure that the Spanish authorities were fully aware of those risks and that they were prepared to follow policies to ensure the success of the integration process.

Spain's economic performance in 1984 had been quite good in most areas, but in some, the authorities had even improved upon their initial aims--for instance, in reducing the fiscal deficit, Mr. Wijnholds continued. Export performance had been particularly good, with a gain in market shares of more than 10 percent. What was perhaps more important, according to the staff, was that structural policies were beginning to change public attitudes, a view that he endorsed. The structural imbalances in the Spanish economy were still considerable and could only be surmounted if there were sufficient public acceptance of ongoing changes. While the authorities had made some courageous moves, they would have to go much further along the route they had begun to travel if they were to achieve full success. The role of inflation remained about 5 percentage points above the EC average, and unemployment, by far the highest rate in Europe at more than 20 percent, was still rising.

In the sphere of fiscal policy, the authorities should take care not only to consolidate the progress achieved, but to bring about a further improvement in the government finances, Mr. Wijnholds considered. Expenditure as a percentage of GNP was increasing once again, and additional efforts seemed necessary to constrain government spending. The Government's pay policy, which implied some decline in real wages, went in the right direction, although the problem of a too large civil service remained. While the authorities understandably had wanted to provide some stimulus to depress domestic demand through lower direct taxes, such action needed to be accompanied by adequate expenditure cuts. Major

improvements had also taken place in the area of public enterprises, whose operating losses had been reduced. There too, more would have to be done to achieve the stated goal of no overall losses by 1988.

The Bank of Spain had the difficult task of carrying out monetary policy and of reconciling the financing needs of the public sector while keeping monetary expansion within reasonable limits, Mr. Wijnholds remarked. The staff had noted that there did not appear to be a major conflict between monetary aims and economic growth objectives. Indeed, the monetary targets set for the current year appeared to be rather accommodative, and they had moreover been exceeded earlier in the year. According to Mr. Pérez, the Bank of Spain foresaw that the increase in the central monetary target--liquid assets in the hands of the public--would be limited to 13 1/2 percent, which would be within the target range. Mr. Pérez had added that that increase would be "fully compatible with the projected GDP growth of 2 percent and an inflation rate of 7 1/2-8 percent through the year." He himself would be inclined to consider that the increase in liquidity would be more compatible with those projections if it were assumed that liquid assets should normally grow in line with nominal GNP, which would indicate an increase of about 10 percent. In point of fact, therefore, a further deceleration of monetary expansion in the year ahead seemed called for.

One of the main problems besetting the Spanish economy was the poor functioning of the labor market, Mr. Wijnholds observed. The problem was not unique to Spain but was encountered in a few European countries. However, the magnitude of the problem in Spain was clearly most serious. It was surprising that with one fifth of the labor force out of work, there was still such resistance to a reduction of wages in real terms. The change of attitude on the part of the public and trade unions still seemed insufficient to ensure a smoother functioning of the labor market, which would go a long way to resolving the unemployment problem. The staff was right to emphasize the need for general wage moderation and to express its concern over wage developments in 1985. The conclusion that wage levels were still too high was inescapable, given the stubborn, extremely high unemployment. It was therefore worrisome to learn that the authorities, in the framework of the tripartite Social and Economic Agreement, held the view that further reductions in real wages were not necessary. The reintroduction of provisions for indexation was also a regressive development. Such developments could make it very difficult for Spain to compete successfully in the industrial sector with other European countries, which would have easier access to the Spanish market after January 1, 1986.

Market penetration was likely to reduce Spain's sizable current account surplus; with imports rising faster than exports, which could not be expected to increase greatly after the spectacular gains made in the recent past, Mr. Wijnholds continued. He agreed with the staff that Spain had no good reason to run surpluses on its current account. A modest deficit would not pose a problem, given the structural inflows of

capital, as shown in Scenario C, the most realistic of the medium-term external debt projections in Appendix III to the staff report. Of course, if international interest rates failed to decline as projected, the debt service ratio would not be halved to 12 percent by 1990, from 24 percent in 1984. Nevertheless, it could be said that Spain had been much more successful than a number of other smaller OECD countries in coming to grips with its external debt obligations.

An active exchange rate policy was likely to be necessary for the time being, Mr. Wijnholds commented. The Spanish authorities' intention to become a member of the European Monetary System at some point in the future was to be welcomed, as was their realism in stating that that was unlikely to be feasible for a while. He wished to underline the staff view that over the medium term, measures to ensure that the economy was more responsive to external competition, to gain a better grip on inflation, and achieve a less regulated economy would be more important than an active exchange rate policy. The benefits of future European Monetary System membership could be reaped only if such an approach was followed.

The quality and timeliness of statistical data was a problem that needed to be dealt with, Mr. Wijnholds remarked. The staff's examples of various indicators revealed serious shortcomings.

To conclude, Mr. Wijnholds commented that the Spanish economy had been moving in the right direction but the serious remaining structural problems would require continuation of a determined policy stance on the part of the authorities to enable Spain to attain higher rates of growth and employment and to integrate the economy successfully into the European Communities.

Mr. Grosche observed that over the past 12 months, Spain had largely stayed a course characterized by supply-side measures to enhance the efficiency of the economy while keeping overall demand at prudent levels. It was a course that had met with overwhelming approval on the occasion of the Executive Board's discussion of the staff report for the 1984 Article IV consultation. Spain's economic policy stance once again deserved the support of the Executive Board. It represented an appropriate attempt to deal with the deep-seated structural weaknesses which continued to be the most burdensome legacy of a long tradition of inward-looking policies. Any cure of those weaknesses must be comprehensive and, given the most likely failure of quick fixes, must be cast in a medium-term framework. Therefore, the approach being pursued by the authorities must lose neither its momentum nor its credibility, all the more so in the difficult political and economic environment within which the authorities had to operate.

Against that background, continued adjustment in public sector finances was essential, Mr. Grosche considered. He welcomed the successful effort to broaden the tax base and the progress in improving tax collection. The staff had covered the need for rehabilitating the social security

system adequately; it was obvious that the system, as it stood, had an adverse impact on the whole economy. He could also follow the staff in its call for streamlining the public enterprise sector. It was evident from Table 2 of SM/85/248 that transfers to enterprises still constituted a major burden for the public budget; those financial resources could be put to more productive use. The active consideration being given by the authorities to the eventual privatization of certain segments of the public enterprises sector was commendable. Given Spain's unemployment situation, the pervasive problem of overstaffing would have to be tackled with some care.

Labor market policies were necessarily a politically sensitive issue, Mr. Grosche continued. However, the authorities' course of engineering a multitude of incentive schemes geared to various segments of the labor market was in all likelihood the wrong way to tackle Spain's labor market problems. In his view, what was needed was a strategy characterized by a reliable and confidence-inspiring institutional framework that placed particular emphasis on gradually reducing nonwage costs and on removing undue costs in the form of severance payments and unemployment compensation. Like Mr. Wijnholds, he was somewhat at odds with the contention of the authorities that no further reduction in real wages was necessary or appropriate. If the high rate of unemployment could not be accounted for by structural factors alone, the prevailing real wage rate was obviously not the market-clearing rate. He would appreciate additional comments by the staff.

The possible conflict between monetary and fiscal policies, which had been appropriately described by the staff, Mr. Grosche remarked, appeared to be less pronounced in 1985, enabling the authorities to follow a more independent monetary policy stance. He shared the staff's concern about the authorities' attempt to hide the true interest cost of financing the budget deficit by placing government debt first with the central bank, which then had to resell the securities at higher rates to the commercial banks. That procedure was doubtful in many respects: in addition to worsening the financial status of the central bank, it did not improve the buoyancy and efficiency of the capital market. If interest rates were to be kept down, in the presence of unchanged financial policies, a more promising avenue would be to break up the oligopolistic banking system in order to allow for more competition.

He was not in full agreement with the staff on external policy, Mr. Grosche commented. Referring to structural capital inflows amounting to 1 percent of GDP, the staff had argued that it made no sense for Spain to run a prolonged current account surplus and that it might therefore tolerate an expansion of exports. However, the strength of the U.S. dollar, which had benefited Spain's exports, and the uncertainties associated with Spain's entry into the European Communities led him to favor a cautious approach. Exchange rates should be monitored closely, in the light of domestic and international inflation rates, with a view to safeguarding Spain's international competitiveness. Though the recent slight

real appreciation of the peseta might be appropriate, exchange rate policy had a role to play in maintaining competitiveness, in addition to the reduction of structural rigidities and prudent financial policies.

In concluding, Mr. Grosche reiterated his full endorsement of Spain's medium-term strategy. The authorities must not lose the momentum they had gained by following that strategy. Spain was a welcome new partner in the European Communities, and would be all the more so if it entered as a strong and competitive partner, thereby enhancing the overall attractiveness of the EC. He supported the proposed decisions.

Mr. Finaish said that three years after the Spanish authorities had embarked on their bold program of corrective action, the foundations of a strong and sustainable economic recovery were clearly being shaped up. Although the persistent increase in unemployment was a source of serious concern, it was also an indication of the magnitude of the economic imbalances that had accumulated over the years. The authorities' adherence to the difficult course of structural adjustment and their avoidance of demand management to deal with an inherently structural problem underlay the visible increase in confidence about the medium-term and long-term prospects of the economy. Consequently, the authorities had been able to continue to reduce the financial imbalance, a requirement if economic recovery was not to be short-lived. Indeed, as Mr. Pérez had outlined them in his statement, economic developments in 1984 and early 1985 were a further indication of the broad balance maintained by the authorities between financial and structural policies.

Referring to fiscal policy, Mr. Finaish said that the continued reduction in the public sector deficit as a percentage of GDP was certainly welcome. But the manner in which the budget deficit was reduced was perhaps more important, especially as it did not seem particularly excessive, with unemployment in the order of 20 percent. The distribution of budgetary outlays, shown in Table 2 of the staff report, indicated clearly that the fiscal imbalance was concentrated in the transfers to public sector enterprises and the social security system. The success of the authorities' structural policies in those two areas should therefore automatically correct most, if not all, of the fiscal problems. Thus, the pace of deficit reduction should reflect progress on the structural front. In fact, by most standards, public sector consumption and investment were relatively small and the tax to GDP ratio was one of the lowest among OECD countries. To the extent that the transfer problem was tackled properly, Spain would have the advantage of fiscal balance without the financial burden of a large public sector; many other countries were trying to resolve the same problem. However, the strong link between structural reform and the fiscal balance did not reduce the importance of proper fiscal management in other areas, such as tax policy. In that respect, recent measures to broaden the tax base and improve tax collection, while at the same time reducing the withholding tax to increase the incentives for private sector activity, were particularly welcome.

Movement toward the structural reform of public enterprises and the basic social security system would inevitably be difficult and gradual, Mr. Finaish noted. However, the substantial progress achieved during the past year in those two areas was quite encouraging. He had noted in particular that savings due to recent changes in the social security system were expected to amount to two thirds of present costs by 1993, which would be a major achievement. The resistance on the part of both employers and labor unions to those reforms indicated that the authorities were doing something right, but it also pointed to the delicate nature of such reform and to the importance of progress in other complementary areas of economic policy.

Similarly, the stabilization of public enterprise losses in 1984 and a projected financial balance by 1988 of the major loss-making enterprises were major achievements, Mr. Finaish added. The budgetary cost of enterprise reform, including privatization, was quite significant. But the authorities rightly considered that the objective was well worth the cost, given the present burden on the budget of transfers and the importance of reforming public enterprises to the longer-term revitalization and competitiveness of the economy.

While monetary restraint had been instrumental in bringing down the rate of inflation, Mr. Finaish continued, the flexible implementation of monetary policy had enabled the authorities to strike a balance between the various domestic and external objectives. Increased reliance on financing the fiscal deficit through the sale of treasury bills, instead of money creation, had also improved monetary management and made the cost of fiscal deficits more transparent. The recent intermediary role played by the central bank in selling treasury bills to banks at a loss was a source of concern. Any advantage of such debt financing, which was a positive development in itself, could be reduced significantly if the central bank was forced to make up for the interest differential by accepting capital losses. It would be useful if the staff could clarify whether--and if so, how--central bank profits and losses were accounted for in the budget. The inability of the Government so far to extend treasury bill sales to the nonpublic also needed to be rectified. The two major structural impediments in that respect appeared to be the oligopolistic nature of the banking sector and government regulations; efforts to overcome them would be in line with the overall strategy of structural reform. Nevertheless, it was not fully clear why, even under present circumstances, a mechanism could not be set up to sell treasury bills directly to the public instead of through commercial banks, which were understandably reluctant to take on the task.

There was no doubt that the employment situation in Spain was the most serious economic and social problem facing policymakers, Mr. Finaish observed. The staff's assessment of the sources of and solutions to, that problem was clearly shared by the authorities, and he had little to add in that respect. The tripartite Social and Economic Agreement for 1985 and 1986 was particularly encouraging. Although an immediate sharp

drop in unemployment should not be expected to result from that agreement, the fact that it addressed the major aspects of the problem--namely, wages, the social security system, and labor market rigidities--raised hopes that the downward trend in employment would be reversed soon. The delicate nature of policy in those areas was obvious and it would not be surprising if further steps met with strong resistance. Indeed, the reinstitution of indexation clauses in the 1985-86 agreement might be an indication of the limits to the Government's labor policy.

At the same time, Mr. Finaish said that he agreed with the staff that it was important for the Government to work for the exclusion of the effects of discretionary tax measures from wage adjustments. The first steps could be made in the public sector, not only because of its leading role in wage setting but also in order to further ease the overmanning problem in that sector and reduce the wage differential relative to private employment. As for the use of selective cuts in social security contributions as a means of encouraging employment of certain groups, the policy had some merit, given the concentration of the unemployment problem among specific segments of the labor force and the dangers that youth unemployment posed for the future efficiency of the economy. Also, it was essential to emphasize the temporary nature of those selective measures so as to prevent their becoming entrenched in the system.

While labor market reform would be a major element in the reversal of the prolonged downward trend in private investment, Mr. Finaish observed, the employment situation itself would benefit from measures to promote private investment. Thus, the success of the Government's industrial reconversion program, as well as the policy of deregulation and of providing investment incentives, would be of vital importance. It was difficult to determine the appropriate mix of reconversion expenditures between the physical upgrading of plants on the one hand, and labor redundancy payments and re-employment incentives on the other hand, but the fact that only one fourth of those expenditures had been for the former suggested that further consideration of the issue by authorities was warranted.

The favorable balance of payments position enjoyed by Spain in 1984 and 1985, and which had been utilized partly to prepay debt, had put the country in a better position to withstand any shocks emanating from its entry into the European Communities, Mr. Finaish concluded. Increased imports from other members of the EC, as well as higher imports associated with increased economic activity, would most probably reverse the current account position in the coming period. He agreed with the staff, however, that that was not a source of concern, provided that exchange rate policy continued to be appropriate and that the authorities adhered to present domestic structural and financial policies. In fact, the balance of risks and opportunities surrounding Spain's entry into the EC depended largely on whether the corrective policies embarked upon since 1982 would be continued and strengthened. The Spanish authorities' record over the past three years suggested that they would be.

Mr. de Forges remarked that by chance the Executive Board had happened to examine, in the space of less than two weeks, the situation of two neighboring countries, Portugal and Spain. Both countries were linked by history and both would in the near future become full members of the EC. He welcomed the opportunity to discuss the Spanish economy, as he had the Portuguese economy.

He fully shared the thrust of the staff appraisal, especially its laudatory assessment of Spain's past course of action and its concern for the future, Mr. de Forges continued. From his understanding of Mr. Pérez's statement, the Spanish authorities seemed to have no quarrel with the staff reports. Indeed, the adjustment process in 1984 had led to real progress, within the authorities' expectations. Among other achievements, he singled out the deceleration of the inflation rate to a single-digit figure; the restoration of balance to the external accounts, with even a surplus on the current account and an increase in the foreign exchange reserves; the control of the growth of monetary aggregates; and the moderation of wage increases, which had allowed a fall in the unit cost of production and the restoration of enterprises' profit margins.

Those forward steps, which were mostly of a short-term character, were nevertheless too modest to give any assurance of their structural nature, Mr. de Forges considered. It had become of the utmost importance for the authorities to lose no time in rising to the major challenge represented by unemployment and by the official entry of Spain into the EC in 1986, which would bring new opportunities but also new adjustment requirements. The effects of the value-added tax on the inflation rate were obvious and so was the impact of increased competition on highly protected domestic industries. In the latter respect, Spain would be exposed to outside shocks from which no sector of the economy would be spared. Even some of the lesser known side effects were worth mentioning; the staff had cited the example of the financial and banking sector, given its present oligopolistic character. Many other such examples could be found.

Since the economic base remained fundamentally fragile, major policy efforts and innovations appeared to be all the more necessary, and in four particular areas, Mr. de Forges observed. First, since productivity in Spain was still 25 percent below the EC average, the productivity gains in the recent period should not be given too much weight. Moreover, according to the staff, "the rise in productivity may have been the result of the rise in real wages rather than the cause thereof...," a statement that gave rise to some worrying thoughts; further comment by the staff would be helpful.

The second area in which further action was required concerned employment, Mr. de Forges commented. Protracted unemployment, which affected almost 22 percent of the labor force, remained the main problem, despite the outlet provided by the underground economy. During the discussion of the staff report for the 1984 Article IV consultation, the

staff had mentioned a study undertaken by the authorities on the latter issue, and he would be interested to learn whether any conclusions had become available yet.

Third, despite some signs of recovery, investment had remained sluggish, and fixed investment, at constant prices, had even decreased by 3 percent in 1984, Mr. de Forges observed. That was a worrisome development, given the imminent opening up of the economy. The weakness of private savings would also have to be dealt with, especially if the authorities were willing to rely less on external financing.

His fourth point was related to the size of the public sector and its overwhelming importance in the economy, both as an employer and as a distributor of resources, Mr. de Forges remarked. Charts 3 and 4 in the staff report brought out vividly the public sector share in dependent employment and domestic credit expansion respectively, and Table 2, to which other Executive Directors had referred, revealed the extent of the Government's role in the economy. Although they had been stabilized in the recent period, subsidies to ailing enterprises remained high--4.5 percent of GDP--while transfers to households were once again on the rise.

His four comments were summarized accurately in the staff assessment that "the disequilibria in the economy appeared to be so deep seated that policy efforts so far may have been able only to stabilize the adverse trends of the past decade toward destruction of employment opportunities and excessive absorption of financial and real resources by the public sector," Mr. de Forges stated.

On more specific issues, Mr. de Forges referred first to fiscal policy. Speaking personally, he would not overcriticize the current level of the general government budget deficit, which, if his understanding was correct, accounted for about 7 percent of GDP. With the present level of unemployment, a balanced budget would appear economically and politically intolerable. That did not mean, however, that priorities could not be set, that the structure of expenditures could not be modified, and that reforms could not be introduced. Given the recent progress made on the revenue side, most of the improvements would have to be sought mainly on the expenditure side. The authorities' decision to no longer lend a compassionate ear to enterprises in financial jeopardy, to put an end to the losses of the public enterprises, and to rationalize the pension system were clearly steps in the right direction. But much remained to be done.

Concerning wage policy, real hourly wages had continued to grow faster than in other high unemployment countries, as had already been mentioned by other Directors, Mr. de Forges remarked. The need to protect the competitiveness of the economy made it crucial to maintain a restrictive wage policy. The numerous schemes designed by the authorities to deal with unemployment had not had the expected results. The

staff was well accustomed to labor market rigidities in Europe; suffice it to say that Spain needed to use imagination more than administrative devices or overregulation.

To conclude, Mr. de Forges noted that the lengthy and strenuous efforts that Spain would still have to make were all the more necessary if past progress and the remarkable performance of the external sector were not to be put in jeopardy. Recent developments gave rise to some concern: monetary constraint had relaxed to accommodate a faster pace of inflation, although he welcomed Mr. Pérez's indication that inflation had moderated recently; wage indexation was a backward step and would add more rigidity to the system; it had become more difficult to finance the public deficit; and the destruction of jobs had not been fully stemmed. In the current less than favorable context, it was important for the authorities to remedy recent slippages and to maintain the general direction of their medium-term policy in order to adjust the structure of the economy and to allow Spanish enterprises to cope with the risks of entry into the EC. As a last thought in his statement on Portugal at EBM/85/133 (9/9/85), Mr. de Maulde had stated that both Europe and Portugal needed the entry of Portugal into the EC to be a success.

Mr. Dallara said that it was appropriate on the eve of Spain's accession to the European Communities to look at the recent accomplishments of the Spanish economy and at its prospects. Like other Directors, he was in general agreement with the staff appraisal and supported the proposed decision. The appraisal had been well pointed in focusing on both the successes of Spain's economic policies in the past few years and on the difficult problems that needed to be tackled.

An examination of the economy in 1982, when the present Government had assumed office, against the current forecast for 1985 demonstrated clearly that economic growth, inflation, and the balance of payments had all improved considerably, Mr. Dallara observed. Mr. Pérez had provided a table that helped to capture the progress made toward meeting those central economic objectives. However, the success had been more mixed insofar as other specific objectives that had been embodied in the medium-term strategy in 1982 were concerned. For instance, restraint in monetary policy continued to be handicapped by the financing needs of the public sector. The ratio to GDP of the central government borrowing requirement had declined by less than 1 1/2 percent since 1982, and transfers to public enterprises as a share of GDP would be slightly higher in 1985 than in that earlier year. The ratio to GDP of social security benefits would also have risen while the ratio of contributions to benefits had fallen. Finally, the unemployment rate, which had risen from about 17 percent to about 21 percent, had been a major objective of economic policy over the past few years.

Some of the figures he had cited might not fully reflect the extent of the progress made in economic adjustment and structural reform, including some initial changes in the labor, fiscal, and financial market areas,

Mr. Dallara remarked. However, some of the ratios he had mentioned did reflect fairly accurately certain serious problems that remained to be dealt with.

Success in dealing with fundamental wage and labor cost problems would clearly depend upon the attainment of a political consensus, Mr. Dallara continued, and it was heartening to note that progress had been made in establishing that consensus. To be effective, the consensus must cover wage restraint, greater wage differentiation, and flexibility in the management of labor resources. The Social and Economic Agreement negotiated for 1985-86 provided some useful guidelines for wage policy and certain labor market and social security reforms. However, he shared the staff's disappointment at the reintroduction of wage indexation at a time when many industrial and developing countries were attempting to move away from such rigid systems that had had significant costs in numerous economies. The continued high proportion of social insurance costs in total labor costs, and the 83 percent share of social security contributions paid by employers, remained serious impediments to new job creation.

He viewed with considerable unease the idea of gradually shifting the source of financing of social benefits from social insurance contributions to the new value-added tax, Mr. Dallara added, on the grounds that that would tend to destroy or certainly weaken the link between benefits and costs. That link could act as a restraint on unrealistic expectations, first, because of the danger that relief provided to employers by way of a reduction in their contributions might over time be eroded by new wage demands, and second, because experience in other European countries suggested that the result might be an ever-increasing role of the Government in the economy, which might have serious adverse affects on the achievement of general economic objectives. He also concurred with the staff's suggestion for a more equal split in the share of contributions paid by employers and employees.

The employment picture continued to be extremely worrisome, as many Directors had noted, although the preliminary data cited by Mr. Pérez in his statement did appear to offer some hope, Mr. Dallara commented. Not surprisingly, the Spanish authorities had tried over the past few years to deal with the problem in a variety of ways. The industrial reconversion plan of 1983 had been providing financing principally for redundancy payments and incentives for the creation of new jobs, but at a higher cost to the budget than originally expected. In addition to generalized incentives for employment and industrial modernization, an array of special incentives was also being offered. Such specific measures as the virtual elimination of rent controls and the liberalization of opening hours were welcome. However, viewed more generally, the complexity of the arrangements and the constant reliance on judgmental decisions by the Government did not seem to be the most effective way to create the needed jobs or to make flexible use of the labor force. He would have

thought that greater reliance on broad macroeconomic measures to establish the needed environment for investment, including greater deregulation of markets for labor and capital, would be the preferred approach.

In the fiscal area, the general government borrowing requirement of nearly 6 1/2 percent of GDP remained high and represented little progress compared with the previous year, Mr. Dallara said. High priority needed to be assigned to expenditure control, which in fact had played very little part to date in reducing the fiscal deficit. Between 1982 and 1985 the ratio of expenditures to GDP of the general government would have risen by almost 2 percentage points while revenues had risen by almost 2 1/2 percentage points. In other words, both the public sector's absorption of resources and the tax burden had increased during that period. Both were worrisome trends. While expenditure restraint in the form of the recent ceiling on public sector hiring and the expected small decline in real wages in 1985 would help, priority attention to reducing transfers to the public enterprises and to the social security accounts was imperative. The phasing out of fiscal support for public enterprises was essential, not just to reduce the fiscal deficit but to expose them to competition from the domestic private sector and from abroad in order to test their long-term economic viability. He also welcomed the modest cut in income tax rates in 1985 as well as the improved collection of indirect taxes.

As was often the case, the problem of fiscal deficits had been reflected in difficulties in monetary policy, Mr. Dallara noted. The recent weakness of private credit demand had tended somewhat to obscure that danger, but economic recovery could be expected to contribute to a re-emergence of the problem unless steps were taken to avoid it. The return of monetary aggregates within the target ranges, as outlined in Mr. Pérez's statement, and some recent financial market reforms were welcome. The substitution of treasury bill issues for noninterest bearing credits from the central bank to finance the deficit should reveal more clearly the cost of public debt and enable the authorities to act more promptly to deal with emerging problems in the implementation of monetary policy. The eventual reduction in portfolio investment requirements imposed on the banks should make them more responsive to changes in lending opportunities.

As for the external sector, other Directors had already noted the impressive achievements on both current account and the overall balance of payments, Mr. Dallara remarked, achievements which had opened up some room for maneuver as Spain entered the European Communities. However, the experience of a number of countries had shown how quickly external positions could be reversed in the absence of sound policies. Therefore, for Spain to maintain a sustainable external position, he would stress the need for a flexible exchange rate, complemented and supported by demand restraint, and firm determination to pursue economic adjustment by means of reform. A continuation of Spain's rather liberal exchange system could help to preserve competitiveness, and eventual acceptance by Spain of Article VIII status would be a welcome development.

In conclusion, Mr. Dallara observed, the Spanish authorities had made some progress over the past three years in achieving growth, in reducing inflation, and in correcting their balance of payments problems. Some initial structural reforms had been introduced to deal with deeply ingrained rigidities, the heritage of a long history of extensive government involvement in the economy and of a rather closed system. The efforts to date had not been minimal; yet the record in terms of the labor market and employment had not been encouraging. He took the lack of full success in those areas as a sign of the need for the authorities to intensify their efforts if their objectives were to be achieved and if they were to be able to take full advantage of the benefits inherent in EC membership and of the closer links that could emerge with the rest of the world economy.

Mr. Lundstrom remarked that, as noted by other Directors, the Spanish economy had developed favorably in many respects during 1984. The rate of inflation had decelerated to 10 percent, the policy of wage restraint had produced some encouraging results, and the Government's objective with respect to the fiscal deficit had been more than achieved in 1984. Indeed, both the public sector deficit and borrowing requirement had fallen relative to GDP in the period 1983-84. Recently, due to a healthy boom in exports, the external deficit had turned into a modest surplus. As the staff had pointed out, through important structural policy changes, the Government had succeeded in increasing the public's confidence and sense of realism. The Spanish authorities should be commended for those achievements.

However, like most other European governments, the Government of Spain had been less successful in bringing down the disturbingly high rate of unemployment, Mr. Lundstrom said. Even more alarming, the level of employment had continued to decline. He hoped that the recent reversal in that trend, to which Mr. Pérez had referred, could be sustained. The labor market situation would present a tremendous challenge to the authorities in the years ahead, whatever the circumstances of the economy in general.

To his mind, efforts would have to be made on two fronts over the medium term, Mr. Lundstrom continued. First, the dismantling of labor market rigidities would have to focus on the flexibility of wages and on lowering the cost of employing and laying off labor. Although the tripartite National Social and Economic Agreement for 1985 and 1986 was welcome in many ways, he urged the authorities to exercise great restraint in respect of wage indexation in particular and wage increases in general. Second, following a long period of contracting fixed business investment, a revival seemed called for; there were indications that investment would increase in 1985 by some 4-5 percent in real terms. An increase in that component of domestic demand was needed to replace and increase production capacity. Given the recent decline in domestic demand, the revival ought to be sustainable without throwing price developments off course.

The improvement in the fiscal area seemed somewhat mixed, Mr. Lundstrom remarked. On the one hand, the fiscal deficit had been narrowed at higher than programmed levels of both revenue and expenditure. If that pattern were to continue, it would be a disturbing development, as the staff had noted. On the other hand, the staff believed that "the seemingly inexorable trend toward an ever higher absorption of private savings by the public sector may not only have been broken, but actually have turned around." That was a most welcome and needed development. The rationalization of the financial situation of the public enterprises had produced some encouraging results by tightening constraints on those entities and containing their operating losses. The authorities might be well advised to continue on that course. Indeed, in the realm of fiscal policy, the authorities' main emphasis had to be on an expenditure policy designed to contain the share of resources absorbed by the public sector.

The monetary program for 1985, in contrast with that for the previous year, did not appear to be in conflict with the current target for real economic growth, Mr. Lundstrom observed. The official strategy of managing monetary growth so as to produce a stable financial environment must be pursued in a way that would give rise neither to increased inflationary expectations nor to too much pressure on interest rates. In that context, he wished to quote the following sentence from the staff report: "With the apparent shift of monetary policy toward a somewhat more accommodating stance than had been adopted in preceding years and the unfortunate coincidence of the reacceleration of the inflation rate--partly weather-induced--the progress made so far toward lowering inflation expectations appears to have come to a halt, if not to have been reversed." He had been led to wonder whether the staff viewed concurrent increased monetary growth and accelerating inflation as being a mere coincidence, and he wondered whether anyone could forecast the Spanish inflation rate.

Spain stood at a crossroads as it entered the European Communities on January 1, 1986, Mr. Lundstrom concluded. The competitiveness of Spanish industry and the flexibility with which the Spanish could adjust to changes in the competitive environment would be put to a test. His constituency wished Spain well in that venture and in the implementation of its so far successful economic strategy.

Mr. Hodgson said that his chair continued to be impressed by the determination of the Spanish authorities to tackle the underlying weaknesses in their economy. The successes of the past year had already been mentioned, as had the remaining concerns, especially the severe structural problems in the labor markets. He would add only four points of emphasis.

First, the Spanish labor market still suffered from considerable rigidities that would have to be dealt with if the intolerable unemployment trend was to be reversed, Mr. Hodgson remarked. That implied a need to re-examine the funding of social security, as well as finding the means to reduce the cost of layoffs to employers. Some steps had been

taken already in that direction but further measures were required. Institutional reform was only a necessary, not a sufficient, condition for improvement in the labor market. Wage awards must remain realistic. There seemed to be little justification for real wage increases in the present economic climate; indeed, real wage reductions were probably necessary.

Second, impressive efforts had been undertaken to strengthen the fiscal balance over the past two years, both through rationalization of certain social expenditures and by strengthening revenue collection, Mr. Hodgson continued. Those efforts would have to continue. Measures to strengthen the public enterprises had also been taken. However, rationalization of those enterprises had been costly, and he urged the authorities to meet their commitment not to provide further funding to those public enterprises that were being privatized.

Third, monetary policy had been too accommodative during the first part of 1985, feeding inflationary expectations, Mr. Hodgson commented. He had therefore been pleased to learn from Mr. Pérez that the monetary authorities had reacted promptly to bring monetary growth rates back within the target band. However, he would appreciate staff comment on Mr. Wijnholds's point on the relationship between the growth of liquid assets in the hands of the public and nominal income growth. He would encourage the authorities were encouraged to examine seriously ways of reducing barriers to entry into financial markets, which could help to lower permanently the cost of financial intermediation.

His fourth and final point of emphasis was that Spain's forthcoming entry into the European Communities would obviously entail costs as well as provide benefits, Mr. Hodgson concluded. Membership in the EC would in all likelihood underline the weaknesses in the Spanish economy, and the external position might well weaken over the few years ahead. In the short term, some modest realignment of the peseta might be required in order to maintain Spain's competitive position vis-à-vis major trading partners. Over the medium term, however, he agreed with other speakers that the authorities should not rely excessively upon devaluation as a means of strengthening the balance of payments position. Fundamental weaknesses had to be tackled with fundamental changes. The authorities had shown impressive judgment over the past few years, and he remained confident in their ability to take and to implement the right decisions.

Mr. Tornetta remarked that the Spanish authorities had achieved commendable progress in 1984. The fiscal deficit and the general government borrowing requirement had decreased, if a large nonrecurrent transaction was excluded. Some progress had also been made in the reform of the social security system and in improving the financial situation of public enterprises. Wage policy had been successful in bringing about a decline in real wages and increased profits in industry and, together with the tightening of financial policies, had led to a decrease in the rate of inflation. Other sizable positive results had been obtained on the external front through a strong export performance.

Notwithstanding those major achievements, developments in other areas were of concern, Mr. Tornetta considered. Gross fixed investment had continued to decline, and the unemployment situation had worsened, with the rate of unemployment reaching an alarming 20.4 percent in 1984. In 1985, there would apparently be some upward pressures on real wages, despite the expected increase in unemployment. Furthermore, decreases in the inflation rate might have run much of their course. Those negative aspects indicated that Spain was suffering from deep-seated structural problems that would have to be tackled with persistent and comprehensive action on the part of the authorities. Spain's entry into the European Communities increased the degree of openness of the economy and would certainly provide a useful stimulus to changes in the medium run. During the period of transition, some growth in imports was likely and the existence of a relatively comfortable foreign reserve position should help the authorities to guard against undesirable developments.

Since he was in broad agreement with the staff report, Mr. Tornetta continued, he would limit his remarks to specific points relating to structural rigidities. A reduction of the high and increasing rate of unemployment was viewed correctly as the main policy objective. Tackling that problem would require a combination of measures to reduce overall labor costs and labor market rigidities alongside measures to create the conditions for increases in domestic investment. Labor costs should be kept under control, both through the continuation of prudent wage policies and by the progressive reduction of the social security costs paid by employers. Some room for maneuver in that respect should be created under the reform described in the staff report that would reduce social security expenditures progressively by tightening rules and controls, together with increased financing of the system by revenues generated from indirect taxes. Yet some redistribution of the cost of social security between the social partners might be considered in view of the heavy burden borne by employers at present. The costs and difficulties related to laying off workers also seemed to have a long-run negative impact on employment, suggesting the need for some modifications in existing procedures. Furthermore, a number of different incentive schemes and regulations affecting the labor market, while they had individual merit, seemed to offer some scope for simplification.

While lower labor costs should have a positive impact on investment by increasing profits, Mr. Tornetta remarked, thought should be given to further measures, such as fiscal incentives, to induce an increase in the rate of capital accumulation. A further stimulus in that respect should result from the increase in competition after Spain entered the EC. The outlook for 1985 had improved, according to Mr. Pérez, with investment activity picking up, after many years of continuous decline, and employment in nonagricultural sectors having increased marginally.

As for financial markets, their efficiency continued to be hampered by a large number of rigidities, and progress in eliminating them had been slow, Mr. Tornetta observed. The transformation margins in the

banking sector were high by international standards, a factor related to the requirement that the banks hold a large part of their resources in certain relatively low-yield assets. That requirement in turn seemed to be connected partly to the below-market yields offered on government or other public sector-related securities, making it difficult for the Government to place adequate amounts on the market. For example, the central bank had had to buy entire issues of treasury bills, and had had to resell them at higher yields. Furthermore, the lack of competition between financial intermediaries seemed to account for some of the high costs of intermediation and some of the difficulties in selling government securities to the public. The costs of the system were transferred to the enterprise sector through the undue increase in the cost of credit. The authorities intended by 1990 to halve the assets that banks had to hold in a certain form, but he wondered whether more rapid progress could be envisaged. More decisive action to bring about a progressive relaxation of regulations allowing interest rates on certain assets to be determined by the market, additional efforts to place government securities directly with the household sector, and greater competition between financial intermediaries were all warranted. The healthy development of the real sector of the economy would have to go hand in hand with greater efficiency in financial markets.

Mr. Ainley said that the Spanish authorities had tackled the imbalances in the economy in a determined way with impressive results, particularly in 1984. Problems remained, however, notably a high level of unemployment and hesitant private investment. Thus, there was little room to relax the current adjustment efforts in the short term. What the staff had called the new mood of realism and confidence might not last unless demand management policies remained firm. It was encouraging to learn from Mr. Pérez that the authorities intended to stay the course.

His main concern for the short term concerned incomes policy, Mr. Ainley added. The introduction of indexation clauses in new wage contracts had potential drawbacks on which he would welcome comment by the staff or Mr. Pérez. Looking to the medium term, many of Spain's problems were clearly structural in nature. Despite the progress made, especially in changing public attitudes, long-standing rigidities persisted in the public finances, the industrial sector, the labor market, and the financial system. The imbalances in those areas would have to be reduced if the authorities were to translate their recent achievements into more permanent gains.

With respect to the public finances, a useful start had been made in broadening the tax base, strengthening the finances of the state pension system, and restructuring public enterprises, Mr. Ainley observed. However, there was scope for further action to put the social security system on a sounder, more lasting financial footing. More far-reaching measures were also needed to deal with the problems of overmanning and low productivity in the public enterprises. Such measures were necessary

not only for budgetary reasons but also to assist in the shift of those enterprises into the private sector, if the authorities carried out their intentions in that respect.

On industrial policy, it was in the longer-term interest of Spain--and of other industrial countries--to shift resources to areas of comparative advantage, Mr. Ainley remarked. Spanish industry must also be in a position to benefit fully from membership in the European Communities. Therefore, he hoped that the authorities would implement fully their restructuring plans, which should help to create new employment opportunities in viable industries. With the same objective in mind, he fully supported the authorities' moves to introduce greater flexibility and greater wage differentiation in the labor market.

He hoped that the authorities would also continue to promote competition and improve efficiency in the financial sector. He agreed with Mr. Finaish's remarks in that respect, particularly on the need to broaden the treasury bill market. In addition, he wondered whether there was scope to develop further the domestic capital markets as a source of longer-term finance for both the public sector and private industry. That sector should be as ready as other sectors to compete effectively when Spain became a full member of the EC, Mr. Ainley stated.

In sum, Mr. Ainley commented, Spain was on the right path and should be encouraged to move more decisively along it. The main priority must be to maintain the momentum of structural adjustment. He supported the proposed decision.

Mr. de Groote remarked that the staff assessment of the Spanish economic situation could be interpreted differently, depending on the time horizon from which it was considered. A comparison of the broad outlines of the situation before the present Government came to power at the end of 1982 with that prevailing at present revealed a successful and courageous record of adjustment. The Government had tried to offset the consequences of the two oil shocks by appropriate demand management measures--acting on the budget, on monetary expansion, on wages, and on the exchange rate--but had also directed its action at some deep-seated rigidities stemming from a long period of dirigism. The absorption of resources by the public sector and the Government's role in determining prices had been greatly reduced. Following that line of reasoning, Mr. Pérez had shown that the slippages in inflation and monetary management at the beginning of 1985 were in the process of being corrected. The economic strategy thus remained fundamentally on track. Government borrowing had been reduced, leading to a decline in interest rates--a development that Mr. Pérez viewed as being favorable, although he was not certain he agreed--and after some considerable effort, government expenditure had also been reduced and tax collection improved. The deficit in 1985 was thus of the same order of magnitude as in 1984.

Viewed from that perspective, Spain appeared to be in a much better position than the staff report suggested, Mr. de Groote continued. External debt had been repaid faster than initially planned, and the continuing large balance of payments surplus would obviously help the country's entry into the European Communities. There had been some growth in investment, some further depreciation of the peseta, which might contribute to maintaining the competitiveness of the economy, and some long- and short-term measures aimed at avoiding large increases in unemployment by subsidizing some enterprises.

However, from the perspective of what was needed in the four or five years ahead for Spain to make an effective entry into the EC and to eliminate rigidities in the economy, different conclusions would have to be drawn, Mr. de Groote considered. Consideration would have to be given to a number of additional efforts to reinforce the role of market mechanisms in the economy and to the further dismantling of the rigidities built up over time. Spain's present course of action seemed unlikely to equip it fully to meet the challenge of the future. Thus, the short-term targets pursued in 1984 might be too modest; the good performance of the economy in that year might have led the authorities to make optimistic forecasts and to relax somewhat their stabilization efforts. If so, it was a disquieting development, because Spain's imminent entry into the EC should have led the Government to take additional action to eliminate the rigidities in the economy.

Real progress had been made recently, thanks to the reform of the pension system, to reduce the budgetary costs of the social security system, which nevertheless continued to exercise undue pressure on the budget, Mr. de Groote went on. In addition, significant subsidies had been granted recently to enterprises to enable them to convert temporary work contracts into permanent ones. There was obviously a great temptation to introduce measures to prevent a further increase in the level of unemployment, with it being so high, but such subsidization did no more than maintain the level of employment artificially. The authorities had little alternative but to pursue a flexible incomes policy, difficult as that might be. Once Spain had become a member of the EC, excessive wage costs would have to be corrected by constant exchange rate adjustments if additional structural adjustment measures were not adopted. There was a real danger that the Spanish public would come to count on the Government to support employment and the social security system and the Government could find itself in the vicious circle of wage increases followed by exchange rate adjustments.

He had been unfavorably impressed by the decision to set as an objective for 1985 the maintenance of real wages, including the reintroduction of major elements of indexation, Mr. de Groote added. It was essential to exclude from the wage index base all elements not related to the underlying rate of inflation--for instance, the value-added tax and the effects of exchange rate changes--if unrealistic expectations were not to be created. The fundamental issue was the need for enterprises to

retain a higher percentage of their value added. Enterprises suffered from low capitalization in relation to available manpower and therefore needed to reconstitute their financial position. It would be difficult for them to do so if the improvement in the Government's budgetary position was the result of an increase in revenue and not of a reduction in expenditure. It was precisely the lack of such a reduction that prevented enterprises from keeping a slightly larger share of the value added in the economy.

The pervasive rigidities in the financial system gave the Bank of Spain a role that should not devolve upon a central bank in normal circumstances, Mr. de Groote observed. Credit for preferred activities was subsidized, and the financial markets were excessively regulated and compartmentalized, leaving little scope for overall monetary policy. The distortion was most obvious in the financing of the general government deficit. The Bank of Spain had incurred capital losses on the sale of government bonds that it had in fact been compelled to purchase at a comparatively low interest rate for resale to the banks at higher rates. It was not uncommon in many European countries for the banking system to be highly oligopolistic and regulated to prevent its exposure to competition. The problem was that private savings were affected adversely, in particular because of the inability to increase the public holdings of treasury bills. Therefore, it was open to question whether the decline in interest rates, which had been viewed by Mr. Pérez as a good feature, was in fact all for the best. It might be more appropriate to take action to let interest rates increase sufficiently to elicit an adequate level of domestic savings and to provide households with access to treasury bills. The negative effects on investment were unlikely to be serious given the present low rate of capitalization of enterprises.

The fact that Spain could approach entry into the EC with high foreign exchange reserves and the prospect of another surplus of $2 billion on the current account and balance of payments in 1985 was cause for great satisfaction, Mr. de Groote stated. Nevertheless, he shared the staff's view that successive and increasing surpluses were of no special value in themselves; on the contrary, appropriate measures should be taken to expand domestic activity, with the emphasis on investment activities rather than consumption. Again, ways would have to be found to promote investment in Spain. The solution to the central problem of employment would have to be a gradual one; it could not be resolved by direct action and certainly not by providing subsidies. Obviously, new opportunities for investment must be created to increase the productive capacity of the economy. Spain had the opportunity to make good use of the large surplus it had built up over time, if it could do so without expanding consumption unduly.

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/85/147 (9/20/85) and EBM/85/148 (9/23/85).

5. SIERRA LEONE - OVERDUE FINANCIAL OBLIGATIONS - REPORT AND COMPLAINT UNDER RULE S-1

1. The complaint of the Managing Director dated September 17, 1985, regarding Sierra Leone's obligation in the SDR Department, in EBS/85/220 (9/17/85) is noted. It shall be placed on the agenda of the Executive Board for September 27, 1985. If at that time Sierra Leone is not current in its obligations to pay charges in the SDR Department, the Fund will consider suspending the right of Sierra Leone to use SDRs it acquires after the suspension pursuant to Article XXIII, Section 2(b).

2. Consideration of the complaint in accordance with Rule S-1 particularly affects Sierra Leone. The member shall be informed by rapid means of communication of this matter and of its right to present its views through an appropriately authorized representative.

Decision No. 8094-(85/148) S, adopted
September 20, 1985

6. GLOBAL EFFECTS OF FUND-SUPPORTED ADJUSTMENT PROGRAMS - PUBLICATION

The Executive Board approves the publication in the Occasional Paper series of the staff paper on the global effects of Fundsupported adjustment programs circulated in SM/85/97, Revision 1 (9/11/85).

Adopted September 20, 1985

7. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of an Assistant to Executive Director and the request that the matter of salary be brought before the Executive Board as set forth in EBAP/70/81 (4/24/70). (EBAP/85/244, 9/18/85)

Adopted September 20, 1985

APPROVED: June 2, 1986

LEO VAN HOUTVEN
Secretary