

Smaller Industrial Countries

During the 1996 financial year, the Fund concluded Article IV consultations with nearly all of its 16 smaller industrial country members. Vigorous economic performance characterized a number of countries, among them Australia, Austria, Ireland, Luxembourg, New Zealand, and Norway. Directors found evidence of an investment-led recovery in economic activity in Greece, and they welcomed Finland's return to a low-inflation growth path. They agreed that a moderation of growth was appropriate in New Zealand in view of that country's high degree of capacity utilization and the sharp drop in the unemployment rate. They also noted that Belgium's economic growth had slowed markedly in parallel with developments in neighboring countries, and that the Swiss recovery was proceeding at a disappointingly slow pace.

For many of these countries—with New Zealand a notable exception—the fiscal position was a principal concern. Directors urged countries to seize opportunities afforded by economic expansions to pursue needed fiscal consolidations, but they also called for perseverance with fiscal discipline in the face of slower growth so that progress could be secured. Activity in a small economy, such as Luxembourg, was susceptible to large fluctuations—a fact that further bolstered the case for a prudent public expenditure policy, the Board observed. They recommended decisive deficit reduction in Finland to stabilize and reverse the rising central governmental debt ratio and urged Austria to step up the pace of its fiscal retrenchment. Directors commended the Irish authorities for containing their fiscal deficit and reducing the ratio of high public sector debt to GNP, but they regretted that the opportunity afforded by strong economic growth to accelerate a reduction in the budget deficit had not been used to full advantage.

Directors believed that further fiscal consolidation was indispensable in Belgium to safeguard that country's hard-currency policy and participation in EMU. They welcomed the medium-term fiscal consolidation plan of the new Government in Australia and noted that it would be important to take steps to raise private saving. Directors welcomed the progress on fiscal consolidation that Greece had made since its last consultation but cautioned against premature relaxation of financial policies, underscoring the need for fiscal discipline to alleviate the burden currently borne by monetary policy and to counter the adverse effects of existing large fiscal imbalances.

High tax burdens in many of these countries effectively limited the scope for revenue-enhancing measures, although Directors emphasized the importance of a further strengthening of tax administration in Portugal and of expanding the tax base and improving tax

compliance in Greece. For most countries, fiscal consolidation would need to rely on a mix of measures that could permanently reduce expenditures. This could entail efforts to contain the wage bill, reduce subsidies and transfers, and in some instances shrink the role of government in the economy. Such steps were recommended in Norway's case, for example, to facilitate its transition, over the longer term, to a competitive post-oil economy.

Directors noted that a reduced ratio of public debt to GNP would provide policymakers with greater flexibility in conducting fiscal policy and in dealing with aging populations and the resultant pressures on pension systems. They commended Finland's success in reaching agreement on reform of its pension system, and supported Luxembourg's initial steps to contain the cost of public sector pensions. They noted that pension reform remains a major concern for many of the smaller industrial countries over the medium term.

Directors commended the credibility of monetary policy in many of the smaller industrial countries, singling out New Zealand's monetary policy framework for special praise. These policies had been effective in containing inflationary pressures throughout New Zealand's economic upswing, and Directors believed that a continued tight monetary policy was appropriate. They also recommended a tightening of monetary policy in other countries, such as Ireland, that were committed to low inflation rates, adding that in a number of countries tighter fiscal policy would prove a useful complement to both monetary and exchange rate policy. Directors welcomed the tightening of monetary conditions in Iceland, and they encouraged authorities to tighten them further to bolster the low level of reserves. Greece's exchange-rate-based monetary policy had been effective in halving inflation from its peak in 1990, but its experience with capital inflows reflected the limits of relying exclusively on monetary policy to secure further reductions in inflation. Directors also commended Portugal's prudent monetary stance, but they urged that monetary and exchange rate policies be more strongly supported by appropriate fiscal policies.

Directors complimented a number of countries on their pursuit of credible exchange rate policies, noting that for several of the European countries the hard-currency policy had well served their needs. They commended Finland for beginning to build up a track record of exchange rate stability. The Board observed that Iceland's stable but adjustable exchange rate policy had contained domestic inflationary pressures and maintained competitiveness, but they expressed concern over continued private capital outflows and a further decline in reserves.

The persistent appreciation of the Swiss franc reflected, in the view of Directors, the high saving rate and the attraction of Switzerland as a safe haven. Cou-

pled with Switzerland's continued integration into the European and global economies, the appreciation made it imperative that the country accelerate the structural adjustment of its economy and increase the flexibility and adaptability of its nontradables sector if a satisfactory level of employment was to be sustained over the medium term.

Directors cited possible tension between buoyant oil revenues and efforts to keep the Norwegian krone stable and inflation low, and they noted that a tighter fiscal stance could help alleviate upward exchange rate pressures. Wage behavior posed the greatest risk to inflation in Finland; Directors believed a tightening of monetary policy might be warranted if wage pressures did build up. They also regretted the fiscal concessions made in Iceland in conjunction with a recent review of the general wage agreement and considered that these costs should have been fully offset by new measures.

Directors complimented New Zealand on its sustained implementation of structural economic reforms and the maintenance of stable macroeconomic policies, which had helped it to achieve a higher potential growth rate. They credited extensive deregulation of the labor market for delaying the emergence of generalized wage pressures, facilitating strong employment growth, and encouraging investment in education and training. Stubbornly high unemployment rates had persisted in many of the other economies, however, suggesting that structural issues lay at the root of these problems. Directors welcomed reforms to increase labor market flexibility, such as Finland's tightened requirements for unemployment insurance, but they agreed that many of these countries would benefit from more vigorous efforts to remove obstacles to job creation. They applauded the decision of the new Australian Government to give labor market reform top priority and welcomed new initiatives aimed at extending competition to public enterprises and other sheltered sectors of the economy.

Directors called on a number of countries, including Portugal, to improve their banking supervision in order to strengthen their financial sectors. They also noted the importance in Iceland of taking steps to further increase the efficiency of the financial sector.

Finally, in keeping with the Fund's data initiative, Directors reviewed the timeliness and accuracy of the data collected by these countries and encouraged a number of them to undertake improvements in certain areas, including external trade and consumer price data and national income accounts.

Australia

The Board concluded the 1995 Article IV consultation with Australia in March 1996. Since the late 1980s, the Australian economy has been progressively integrated into the global economy through a decline in tariff protection and far-reaching financial deregulation. Against this backdrop, Executive Directors welcomed the generally favorable performance of the Australian economy in recent years, reflected in over four years of sustained growth, much lower inflation, and significant employment gains (see Table 12). However, Directors observed that the Australian economy faced two key structural constraints—the long-term deterioration in the current account position that had resulted in the

Table 12

AUSTRALIA: SELECTED ECONOMIC INDICATORS

(Data as of Board discussion in March 1996; annual percent change unless otherwise noted)

	1991/92	1992/93	1993/94	1994/95
Domestic economy				
Real GDP	0.7	3.2	4.4	4.5
Unemployment rate	10.3	11.0	10.5	8.9
Consumer price index	1.9	1.0	1.8	3.2
External economy				
Exports, f.o.b. (in billions of Australian dollars)	54.9	60.0	63.9	66.4
Imports, f.o.b. (in billions of Australian dollars)	51.1	59.4	64.4	74.7
Current account balance (in billions of Australian dollars)	-11.6	-14.9	-16.7	-27.6
Gross direct investment (in billions of Australian dollars)	...	112.5	121.9	128.6
Portfolio investment (in billions of Australian dollars)	...	127.5	122.9	126.8
Capital account (in billions of Australian dollars)	14.9	14.3	13.2	23.1
Gross external debt (in billions of Australian dollars)	191.3	208.4	205.9	223.3
Real effective exchange rate (1989/90 = 100)	89.5	82.1	77.3	78.6
Net international reserves (in millions of U.S. dollars)	16.7	14.0	15.1	14.3
Financial variables				
General government balance (in percent of GDP)	-4.6	-4.7	-3.1	-2.4
Broad money	0.8	2.3	1.3	7.8
Interest rate (ten-year bond)	9.9	8.3	7.4	9.9

accumulation of high external indebtedness, and a structurally high unemployment rate. Moreover, Directors were also concerned that demand pressures would spill over to worsen further the external account and rekindle inflation. To address these issues, the authorities have developed a comprehensive policy strategy based on raising national saving, locking in low inflation, and making product and factor markets more flexible.

Directors believed that medium-term fiscal consolidation would be critical in raising national saving, reversing the deterioration in the external accounts, and sustaining growth performance. Directors welcomed the new Government's aim to achieve underlying budget balance by 1997/98. They generally shared the authorities' view that fiscal consolidation should focus mainly on the spending side. Directors also noted the decline in private saving and the importance of providing an economic environment that encouraged private saving. The authorities' commitment to price stability has been supported by the forward-looking and more transparent monetary policy framework.

With demand expected to remain strong, Directors considered that financial policies needed to remain firm to keep domestic costs in check and to ensure that underlying inflation returned to its target range of 2–3 percent. Some Directors believed that there was a case for further monetary tightening, particularly if the economy gave indications of more robust growth. Several suggested that greater specificity of the inflation target might clarify expectations and afford rapid credibility gains as the target was achieved.

In recent years the authorities have undertaken many initiatives to overcome structural impediments in the economy. These have included far-reaching initiatives to extend competition to public enterprises and other sheltered sectors of the economy as well as policies to promote a more flexible and efficient labor market by supporting a gradual shift in the focus of the industrial relations system away from centrally determined awards toward enterprise-based bargaining. Directors commended these, but noted that other challenges, particularly the challenge of reducing unemployment, remained. They observed that significant rigidities in the labor market reduced the effectiveness of enterprise bargaining and heightened the risk that wage settlements could run ahead of productivity improvements. Therefore Directors strongly welcomed indications that labor market reform aimed at facilitating enterprise bargaining would be a top policy priority of the Government. They also urged that attention be given to other potential causes of high unemployment, such as the levels of nonwage labor costs and social welfare benefits that could reduce work incentives. Some Directors also pointed to the need to improve

the skills and productivity of workers to enhance external competitiveness.

Directors welcomed the authorities' continued commitment to liberal trade policies. Some Directors suggested further trade liberalization, especially tariff cuts, to strengthen competition. The authorities were also encouraged to raise their official development assistance.

Austria

When Directors met in May 1995 to discuss its 1995 Article IV consultation, Austria was experiencing a robust economic upturn following a relatively mild recession in 1993. Both foreign and domestic demand was growing vigorously. Private consumption was strengthening, and fiscal policy remained expansionary. Growth in wage earnings continued to decelerate, reflecting the effects of the 1993 stabilization pact between the Government and its social partners. In view of this development and of nearly stable import prices, deceleration in consumer price inflation (3.6 percent in 1993 to 3.0 percent in 1994) remained slow. Nevertheless, profit margins in the service sector increased, while profitability in manufacturing rose to its highest level since the early 1970s.

Monetary policy continued to be guided by the close link of the Austrian schilling to the deutsche mark. Having established the credibility of this policy, the authorities were able to allow monetary conditions to ease. Short-term interest rates remained below those in Germany. The nominal effective exchange rate of the schilling was broadly stable. The external current account deficit, however, widened in 1994 to about 1 percent of GDP because of the strong cyclical rebound in imports and a sizable decline in net earnings from tourism. (See Table 13.) Nonetheless, net capital inflows were sufficient to finance the current account deficit.

The underlying position of public finances deteriorated in 1994 for the second year in a row. The structural deficit approached 3 percent of GDP in 1994, reflecting higher expenditures on entitlement programs and shortfalls in receipts from corporation tax and the tax on investment income. Over the two years to 1994, the gross public debt increased by 5 percent to reach 63 percent of GDP.

Directors, welcoming the 1995 Article IV consultation as the first since Austria had joined the European Union, noted with satisfaction the good economic situation in Austria. The economy had revived swiftly from the mild 1993 recession, and strong growth was likely to continue. Unemployment was remarkably low by European standards. Directors expressed concern, however, about the weakening of public finances, which could only partly be attributed to transitory factors and was worrisome because it coincided with Aus-

tria's assumption of the Maastricht Treaty objectives.

Directors were unanimous in their view that the restoration of a sound fiscal position should be the main policy priority for the next few years. They urged the authorities to step up the pace of fiscal retrenchment in 1996. They emphasized that Austria should use present and prospective economic expansion to lower the general government deficit to below the Maastricht criterion of 3 percent of GDP and to reverse the upward trend in the public deficit ratio to below the 60 percent EMU ceiling. Entitlement programs needed to be cut to reduce the federal deficit.

Directors commended the authorities on the smooth and speedy entry of the schilling into the exchange rate mechanism of the European Monetary System (EMS). At the same time, they emphasized that strict adherence to an ambitious program of fiscal consolidation would be essential to safeguard the link between the schilling and the deutsche mark and to maintain the low interest rate differentials with Germany.

Directors agreed there was scope to increase competitive pressures, particularly in the sheltered service sector. Similarly, action was called for to reduce undue incentives to early retirement in order to raise labor force participation, to contain nonwage labor costs, and to ensure the long-term viability of the pension system.

Following the consultation, the general government deficit widened to about 6 percent of GDP in 1995. After elections were held in December 1995, the new Government prepared in early 1996 a bold fiscal consolidation program for 1996–97, with two thirds of the adjustment on the expenditure side. The program is aimed at reaching the Maastricht deficit criterion of 3 percent of GDP in 1997. In April 1996, Parliament approved the Government's two-year budget, including the measures required to implement the Government's fiscal consolidation program.

Finland

When Directors met in early September 1995 to conclude Finland's Article IV consultation, economic developments in that country appeared to be marked by robust growth. Domestic demand was recovering,

inflation remained low, and the external current account was in surplus. Nevertheless, unemployment remained high, and capacity constraints were evident in some export industries.

After falling a cumulative 13 percent over the previous three years, real GDP expanded by 4 percent in 1994 and continued its strong growth in early 1995. (See Table 14.) The rate of unemployment fell from a high of 19 percent in early 1994 to 17 percent in April 1995. Subsequent to its being floated in September 1992, the markka depreciated sharply. This devaluation, along with improved productivity, laid the basis for vigorous export-led recovery, in which export volumes rose by 10 percent for three consecutive years. During 1994, the current account of the balance of payments went into surplus for the first time in 15 years. Signs of transition to a more balanced recovery subsequently became evident. Private investment is up and domestic demand has increased. Moreover, the increase in exports in 1994 was based not on depreciation of the currency (the markka had in fact appreciated by 25 percent since early 1993), but on recovery in partner countries, including the transition

Table 13

AUSTRIA: SELECTED ECONOMIC INDICATORS

(Data as of Board discussion in May 1995; annual percent change unless otherwise noted)

	1992	1993	1994 ¹	1995 ²
Domestic economy				
Real GDP	1.8	-0.1	2.7	3.0
Unemployment rate	3.6	4.2	4.4	4.2
Consumer price index	4.1	3.6	3.0	2.7
External economy				
Exports, f.o.b. (in billions of schillings)	487.6	467.2	512.5	560.0
Imports, c.i.f. (in billions of schillings)	593.9	564.9	628.9	663.0
Current account balance (in percent of GDP)	-0.1	-0.4	-1.0	-1.1
Direct investment (in billions of schillings)	-10.2	-5.6	0.7	...
Portfolio investment (in billions of schillings)	-29.8	-20.4	-48.3	...
Capital and financial account balance (in billions of schillings)	21.1	0.5	32.0	...
Real effective exchange rate	1.4	1.8	-2.2	...
Net international reserves (in billions of schillings)	-119.0	-139.0
Financial variables				
General government balance (in percent of GDP)	-3.3	-4.6	-4.7	-4.3
Gross fixed investment	1.3	-2.1	5.5	5.8
Broad money	4.2	4.0	5.3	...
Interest rate (six-month interbank rate)	9.4	6.8	5.2	...

¹Preliminary.

²Projected.

Table 14

FINLAND: SELECTED ECONOMIC INDICATORS

(Data as of Board discussion in September 1995; annual percent change unless otherwise noted)

	1992	1993	1994	1995
Domestic economy				
Real GDP	-3.6	-1.6	3.9	5.0
Unemployment rate (in percent)	13.1	17.9	18.4	16.5
Consumer price index	2.6	2.2	1.1	1.5
External economy				
Exports, f.o.b. (in billions of markkaa)	105.8	132.6	152.2	174.3
Imports, c.i.f. (in billions of markkaa)	93.2	101.6	118.6	133.5
Current account balance (in percent of GDP)	-4.6	-1.0	1.1	2.5
Direct investment, net (in billions of markkaa)	5.2	-4.6	-12.0	...
Portfolio investment, net (in billions of markkaa)	34.8	35.1	37.4	...
Capital and financial account balance (in billions of markkaa)	13.9	0.9	23.5	...
External debt, net (in percent of GDP)	48.2	55.1	50.2	...
Real effective exchange rates	-17.5	-15.9	6.3	4.5 ¹
Net international reserves (in billions of U.S. dollars)	5.3	5.5	10.7	11.1 ¹
Financial variables				
General government balance (in percent of GDP)	-5.9	-7.8	-5.6	-4.7
Gross national saving (in percent of GDP)	12.1	13.6	17.5	21.0
Gross fixed investment	-16.9	-18.6	4.1	15.1
Broad money	-0.1	3.8	1.9	-0.3 ¹
Interest rate (three-month money market)	13.3	7.7	5.4	6.0 ²

¹First quarter 1995.²June 1995.

economies, and on improved terms of trade, as pulp and paper prices had rebounded. In 1995 inflation had remained subdued, although several factors pointed toward higher consumer price inflation in the period ahead. Despite some reduction in expenditure, the central government fiscal deficit widened slightly to 10.5 percent in 1994, and no improvement was envisaged in 1995. This has occurred, among other factors, because of an increase in employee benefits, the cost of accession to the European Union, and the failure of fiscal measures to effect sufficient structural change.

In their discussion, Directors noted that recent developments in Finland owed much to steady financial policies pursued over the past three years. They stressed, however, that sustaining the growth needed to reduce unemployment without reawakening inflation would require greater fiscal consolidation supported by wage restraint, labor market reform, and other structural change. They welcomed the tightening of eligibility requirements for unemployment insur-

ance, but noted that further reforms were needed because the current generosity of benefits was seen as weakening the restraining influence of the unemployed on wage demands. Although they expressed concern at the continued large fiscal deficits, they welcomed the draft budget for 1996, which was fully consistent with the previously announced fiscal program. In their view, the budget envisaged a significant reduction in the deficit and focused appropriately on measures that would permanently lower expenditures. They observed that the credibility of the Government's strategy had been bolstered by measures, such as the agreement on pension reform, that would yield significant saving over the long term.

Directors pointed to the low level of inflation and to the strength of the markka as tangible indicators of the success of monetary policy in the preceding year. They stressed that the inflation target should remain the focus of monetary policy and agreed that, with the Government committed to fiscal consolidation, wage behavior posed the greatest risk to the inflation outlook. Directors observed that substantial currency appreciation had taken place and that Finland had started build-

ing a track record of exchange stability. They felt that additional market-driven appreciation need not be resisted.

Directors welcomed indications that Finland was making convincing progress toward integration into the European Union, but they noted that the challenge of integration reinforced the importance of structural reform. They expressed the hope that, notwithstanding budgetary constraint, Finland should be able to restore its traditionally generous provision of official development assistance.

Since the time of the Article IV consultation, the economic environment changed significantly. Reflecting primarily external shocks (particularly the economic slowdown in Europe), GDP growth declined markedly in the second quarter of 1995. Moreover, the wage agreement concluded in late September involved moderate wage increases for both 1996 and 1997. Against this background, the Bank of Finland eased monetary policy significantly, reducing its tender rate by a total

of 2.25 percentage points between October 1995 and March 1996.

Developing Countries

Over the course of the 1996 financial year, the Board held more than ninety Article IV consultations with developing countries. Many countries were commended for their impressive pursuit of economic reform—often with the financial support of the Fund. Their aggregate record of strong growth with low or declining inflation was seen as reflecting the pursuit of prudent policies coupled with determined structural reforms. Most, however, require some further macroeconomic and structural adjustment; Directors counseled perseverance in creating the sound macroeconomic policy environment that is needed to sustain high-quality growth. Financial markets tended to react quickly to any faltering of countries' adjustment and reform efforts, and were now holding countries to a higher standard, Board members observed.

The robust aggregate performance of the developing countries masked widely divergent experiences among individual countries. While some countries had registered successive years of brisk growth, a number of other countries remained mired in a vicious circle of low growth, high inflation, and intractable external indebtedness. Directors stressed the vital importance of laying a solid foundation for growth and fostering the development of a vigorous private sector. For many developing countries with youthful populations about to swell the size of their workforce, a dynamic private sector was viewed as offering a key to higher growth and expanded employment opportunities. Directors emphasized that in many countries there was still considerable scope to reduce the role of government in the economy, encourage growth in the private sector, and shift needed resources to public sector investments in human resource development and infrastructure. They also noted the crucial role that governments play in shaping and sustaining a policy environment conducive to high-quality growth.

The Board cited civil order as a key precondition for both reform and growth. Sound macroeconomic policies and a vibrant private sector were unlikely to take root in conditions of strife and uncertain security. Directors hoped that several countries would soon be able to re-establish the conditions necessary for civil order and growth; they also commended a few countries that had recently emerged from conflicts and were, with the assistance of the Fund and others, attempting to rebuild their economies.

In most of their discussions with member countries, Directors stressed the importance of strengthening fiscal discipline. They frequently underscored the need to address public sector deficits to ensure that these did not produce inflationary pressures or stifle private sec-

tor development. They cautioned a number of countries about rising or persistently high public sector debt. More generally, they emphasized the role that strong fiscal policies play in achieving and consolidating macroeconomic stability, ensuring adequate revenues, promoting higher domestic saving (and lower government dissaving), and stimulating investment. To ensure the adequacy of revenues, they often recommended expansion of the tax base and, in some instances, implementation of sales or value-added taxes, as well as improved tax administration and efforts to combat fraud.

In many instances, however, revenue-enhancing measures needed to be complemented by firm expenditure restraint. In particular, Directors observed that restraint in the public sector wage bill, which figures as a key element in many developing country government expenditures, could free up resources for more productive public and private sector investment. In some instances, public sector wage restraint could also exert a useful demonstration effect on private sector wages—thus helping countries to maintain or enhance external competitiveness.

Directors underscored the need to make effective use of resources and eliminate unproductive expenditures. In this regard they counseled a number of countries to end general subsidies, reduce military expenditures, and better target social safety nets. Reduced spending on unproductive activities would allow countries to shift resources to needed investments in human and physical capital, notably in health, education, and physical infrastructure. In addition to identifying unproductive expenditures, some countries would need to take broad and basic steps to rationalize and prioritize expenditures and to improve budgetary management. In many of their discussions, Directors urged countries to complement expenditure restraint with accelerated privatization and public enterprise reform.

On the monetary side, Directors commended a number of countries for pursuing appropriate monetary policies that had produced low inflation and a stable macroeconomic environment. They urged continued diligence where progress had been made and greater effort, in the context of comprehensive reforms, to stabilize the economy and bring down inflation where high rates continued to undermine growth prospects. Directors noted that wage indexation in some countries posed a serious obstacle to efforts to subdue inflation.

Where a change in monetary policy was recommended, it was often a move to tighten the monetary stance in response to underlying changes in the economy. Directors considered, for instance, that tighter monetary policies were indicated in several countries that had enjoyed extended periods of strong growth