



ARTICLE IV CONSULTATIONS

The Fund holds bilateral consultations with all its member countries, in most cases every year, under the provisions of Article IV of the Articles of Agreement. As part of these consultations, a staff team from the Fund visits a country to discuss with officials economic developments and the monetary, fiscal, and structural policies that the authorities are following. The team also gathers relevant economic and financial information on the economic situation facing the country. On its return to Fund headquarters, the team prepares a report analyzing the economic situation and evaluating the stance of policies, which serves as the basis for the Board's discussion. At the end of the discussion, the Chairman of the Board summarizes the views expressed by Directors during the meeting. This summary is transmitted to the country's authorities. In April 1997, the Board agreed to issue Press Information Notices, on a voluntary basis, following the conclusion of members' Article IV consultations (see Chapter 4, the section "Biennial Review of Surveillance," and Appendix V). During 1996/97, 150 consultations under Article IV were concluded by the Fund (Table 3).

This chapter describes the main elements of the Board's discussions of a number of Article IV consultations with member countries. The countries have been selected on the basis of their importance in the global or regional economy, with some smaller countries being included on a rotating basis. Each country description provides a short account of significant macroeconomic and structural developments at the time of the consultation, together with a table of the main economic indicators available to the Board at that time. This is followed by a summary of the conclusions of the Board's discussion. In a number of cases, where a consultation was held early in the financial year and there were significant subsequent developments, an additional column of updated staff estimates has been added to the table of selected economic indicators. Also, in some cases where there were significant policy developments in a member country since the consulta-

tion was concluded, an additional paragraph has been added to the text.

Advanced Economies

Major Industrial Countries

United States

The Board concluded the Article IV consultation with the United States in July 1996. This came after a year of rebounding economic activity (Table 4), with growth accelerating in the third quarter of 1995, slowing in the fourth quarter, and rising again to 2.3 percent (annual rate) in the first quarter of 1996. In the final quarter, growth was largely driven by the strength of consumption and private fixed investment, which more than compensated for the negative effects of inventory investment and net exports. The unemployment rate hovered around lows of 5.6 percent during 1995 and early 1996, as employment grew strongly and the participation rate rose.

Consumer price inflation during 1995 was 2.8 percent, in line with the average over the past four years, while inflation measured by the producer price index and the GDP deflator registered small increases. Inflation at the consumer and producer levels rose during the first five months of 1996 owing to weather-induced increases in food and energy prices.

Steady progress had been made in reducing the fiscal deficit, which fell from 3 percent of GDP in fiscal year 1994 (ending in September) to 2.3 percent in fiscal year 1995, reflecting expenditure cuts, tax increases, and the effects of the economic recovery. Owing to larger-than-anticipated revenue in the first seven months of fiscal year 1996 and to constraints on spending, the federal fiscal deficit for the fiscal year was estimated at the time of the consultation to decline to about 1.6 percent of GDP.

The Federal Reserve Board had begun to ease monetary policy in July 1995 in response to a slowdown in economic growth and evidence that potential inflation-

Table 3
Article IV Consultations Concluded in Financial Year 1997

Albania	February 28, 1997	Guatemala	October 16, 1996	Norway	February 24, 1997
Algeria	June 26, 1996	Guinea	January 13, 1997	Oman	March 21, 1997
Antigua and Barbuda	July 19, 1996	Guinea-Bissau	March 21, 1997	Panama	July 19, 1996
Argentina	October 30, 1996	Guyana	October 9, 1996	Papua New Guinea	December 20, 1996
Armenia	September 23, 1996	Haiti	October 18, 1996	Paraguay	July 19, 1996
Australia	February 19, 1997	Honduras	December 2, 1996	Philippines	December 20, 1996
Austria	May 24, 1996	Hong Kong, China	February 21, 1997	Poland	March 7, 1997
Azerbaijan	December 20, 1996	Hungary	August 28, 1996	Portugal	October 18, 1996
Bahamas, The	October 11, 1996	Iceland	February 10, 1997	Qatar	June 7, 1996
Bangladesh	August 28, 1996	India	November 4, 1996	Romania	April 23, 1997
Barbados	November 15, 1996	Indonesia	July 26, 1996	Rwanda	November 18, 1996
Belarus	July 31, 1996	Iran, Islamic Republic of	August 23, 1996	San Marino	July 24, 1996
Belgium	February 7, 1997	Ireland	July 1, 1996	São Tomé and Príncipe	June 21, 1996
Benin	August 28, 1996	Israel	December 18, 1996	Saudi Arabia	February 24, 1997
Bhutan	December 6, 1996	Italy	April 4, 1997	Senegal	June 28, 1996
Bosnia and Herzegovina	August 26, 1996	Jamaica	July 26, 1996	Singapore	February 7, 1997
Botswana	March 5, 1997	Japan	July 24, 1996	Slovak Republic	March 19, 1997
Brazil	March 3, 1997	Jordan	February 10, 1997	Slovenia	December 16, 1996
Brunei Darussalam	May 1, 1996	Kenya	March 21, 1997	Solomon Islands	June 26, 1996
Burkina Faso	February 14, 1997	Korea	November 15, 1996	South Africa	May 29, 1996
Cambodia	February 3, 1997	Kuwait	August 19, 1996	Spain	May 3, 1996
Cameroon	October 9, 1996	Kyrgyz Republic	July 31, 1996	Spain	March 19, 1997
Canada	January 29, 1997	Lao People's Democratic Republic	May 8, 1996	Sri Lanka	July 31, 1996
Cape Verde	August 26, 1996	Latvia	November 25, 1996	St. Lucia	November 15, 1996
Central African Republic	February 21, 1997	Lebanon	July 3, 1996	St. Vincent and the Grenadines	November 8, 1996
Chad	May 22, 1996	Lesotho	September 23, 1996	Sudan	February 12, 1997
Chile	August 30, 1996	Libya	August 28, 1996	Swaziland	March 7, 1997
Comoros	August 30, 1996	Lithuania	June 26, 1996	Sweden	September 9, 1996
Congo, Republic of	June 28, 1996	Macedonia, FYR	April 11, 1997	Switzerland	February 12, 1997
Costa Rica	June 14, 1996	Madagascar	May 17, 1996	Syria	March 24, 1997
Côte d'Ivoire	November 15, 1996	Malawi	June 19, 1996	Tajikistan	May 8, 1996
Croatia	March 12, 1997	Malaysia	August 30, 1996	Tanzania	November 8, 1996
Czech Republic	November 27, 1996	Maldives	July 10, 1996	Thailand	July 17, 1996
Denmark	February 24, 1997	Mali	November 25, 1996	Togo	February 3, 1997
Dominica	July 1, 1996	Marshall Islands	August 21, 1996	Tonga	January 27, 1997
Dominican Republic	May 15, 1996	Mauritius	March 10, 1997	Trinidad and Tobago	March 24, 1997
Egypt	October 11, 1996	Mexico	August 2, 1996	Turkey	August 26, 1996
Equatorial Guinea	November 27, 1996	Micronesia	August 21, 1996	Uganda	May 1, 1996
Eritrea	June 12, 1996	Moldova	September 23, 1996	Uganda	April 23, 1997
Estonia	July 29, 1996	Morocco	December 6, 1996	United Arab Emirates	October 9, 1996
Ethiopia	May 1, 1996	Mozambique	November 18, 1996	United Kingdom	October 23, 1996
Fiji	August 21, 1996	Myanmar	March 5, 1997	United States	July 22, 1996
Finland	July 29, 1996	Namibia	July 3, 1996	Uruguay	July 26, 1996
France	October 16, 1996	Nepal	May 29, 1996	Uzbekistan	June 26, 1996
Georgia	September 23, 1996	Netherlands	June 3, 1996	Vanuatu	June 26, 1996
Georgia	March 21, 1997	Netherlands Antilles	March 3, 1997	Venezuela	July 12, 1996
Germany	September 6, 1996	New Zealand	November 25, 1996	Vietnam	November 27, 1996
Ghana	June 21, 1996	Nicaragua	October 9, 1996	Western Samoa	March 12, 1997
Greece	August 2, 1996	Niger	June 12, 1996	Yemen, Republic of	July 15, 1996
Grenada	May 29, 1996	Nigeria	February 3, 1997	Zambia	July 8, 1996

ary pressures were abating. By January 1996 the target rate for federal funds had been reduced to 5¼ percent and was kept there for the first half of 1996. Long-

term rates fell by about 2 percentage points over 1995 but rose by over 100 basis points in the first half of 1996, primarily reflecting evidence that economic

growth in the first half of 1996 was picking up faster than expected.

The dollar, which had recovered in late 1995 from historical lows against the yen and the deutsche mark, appreciated somewhat further in early 1996 in response to the rise in U.S. interest rates. The current account deficit narrowed slightly to 2.0 percent of GDP in 1995. The merchandise trade deficit was unchanged at 2.4 percent of GDP. Net private capital inflows fell substantially in 1995, as banking and direct investment shifted to net outflows, which were only partially offset by a large increase in net foreign purchases of U.S. securities.

In their discussion, Directors praised the U.S. economy's strong performance, noting in particular the continued growth with impressive employment creation and low unemployment rates while inflation was kept in check. They also commended the expert handling of monetary policy and the achievement in reducing the fiscal deficit.

Directors agreed that the immediate challenge was to maintain the progress in reducing inflation. The pace of economic activity had quickened since the beginning of 1996, with domestic demand increasing rapidly. As a result, the economy was operating at a high level of resource utilization, and the unemployment rate had fallen to low levels. Moreover, it appeared that the economy's considerable strength would carry over to the second half of the year. Given these conditions, most Directors agreed that an early tightening of monetary conditions would be needed to ensure that inflationary pressures did not emerge and to prevent the buildup of adverse expectations and uncertainty in stock and bond markets.

In view of the low level of U.S. national saving and the imbalance between saving and investment, most Directors believed that the federal budget deficit remained the main economic policy challenge in the medium term. Therefore, it was important to consolidate into legislative action the consensus on achieving a balanced budget by fiscal year 2002. Several Directors considered that the effort needed to balance the budget might have to be greater than envisaged. Questions were raised about the feasibility of substantial further

cuts in discretionary spending and whether the saving from the proposed entitlement reforms would be as large as assumed. Furthermore, since much of the deficit reduction envisaged by the authorities would be achieved late in the budget's time horizon, Directors noted that tax cuts should be delayed until significant progress toward a balanced budget had been made. It would also be important to act expeditiously to address the impending fiscal pressures expected to result from the aging of the U.S. population.

On medium-term monetary policy, Directors agreed price stability should be the primary long-term objective. They endorsed the Federal Reserve's handling of monetary policy, including its careful attention to signs of emerging pressure. They commended its willingness to act preemptively on the basis of its assessment of where the economy was heading; this had contributed to the enviable anti-inflation record.

Table 4
United States: Selected Economic Indicators
(Data as of Board discussion in July 1996)¹

	1993	1994	1995	1996	
				Projections at time of Board discussion	Outturn ²
<i>In percent</i>					
Domestic economy					
Change in real GDP	2.3	3.5	2.0	2.2	2.4
Unemployment rate	6.9	6.1	5.6	5.6	5.4
Change in consumer prices (end of period)	2.8	2.7	2.5	2.9	3.3
<i>In billions of U.S. dollars¹</i>					
External economy					
Exports, f.o.b.	456.8	502.5	575.9	615.2	611.7
Imports, f.o.b.	-589.4	-668.6	-749.4	-788.9	-799.3
Current account balance	-99.9	-148.4	-148.2	-150.9	-165.1
Direct investment	-35.1	-4.7	-35.3	...	-4.4
Portfolio investment	-41.8	31.0	95.6	...	180.9
Capital account balance	56.4	134.7	116.6	...	218.2
Gross official reserves	70.8	45.6	100.0	...	129.4
Current account balance (in percent of GDP)	-1.5	-2.1	-2.0	-2.0	-2.2
Change in real effective exchange rate (in percent)	2.6	-1.1	-5.5	...	5.9
<i>In percent of GDP¹</i>					
Financial variables					
General government balance	-3.6	-2.3	-2.0	-1.5	-1.4
Gross national saving	14.3	15.2	15.9	16.0	16.8
Gross national investment ³	16.5	17.7	17.7	...	17.8
Change in broad money (M2; year-over-year; in percent)	1.1	1.4	2.1	...	4.9
Three-month treasury bill rate (yearly average; in percent)	3.0	4.2	5.5	5.2	5.1

¹Unless otherwise noted.

²Updated Fund staff estimates.

³Includes net capital grants received by the United States.

Directors were generally satisfied that the strengthening of the U.S. dollar had helped to moderate aggregate demand in the United States and had contributed to economic recovery in other major industrial countries. However, they noted that the U.S. current account deficit remained large and that the net foreign liabilities of the United States continued to increase. They saw further tightening of fiscal policy over the medium term as the best means of raising national saving and contributing to a reduction in U.S. demands on global saving.

Directors commended the U.S. support for trade liberalization in multilateral and regional forums. They urged the authorities to take full advantage of the strengthened dispute settlement procedures of the World Trade Organization (WTO), and they stressed that unilateral trade policy actions by the United States risked undermining the effectiveness of the multilateral trading system. Directors expressed regret over the decline in U.S. official development assistance in terms of GDP and over U.S. arrears to multilateral institutions.

Subsequent to the consultation, the pace of economic activity slowed in the third quarter of 1996, but it rose sharply in the fourth quarter and maintained a very rapid pace in early 1997. The economy moved to a very high level of resource utilization; output growth exceeded estimates of the economy's potential growth rate, and the unemployment rate fell from 5.8 percent in early 1996 to between 5.2 and 5.4 percent in the second half of 1996 and the first part of 1997. Despite continued high levels of resource utilization, there was little direct evidence of inflationary pressures, with core consumer price inflation (the consumer price index excluding food and energy) declining somewhat during 1996 and into 1997. Nevertheless, citing the need for monetary policy to be forward looking and concerns about the persistent strength of aggregate demand, with its attendant risks for inflation prospects, the Federal Open Market Committee acted to tighten monetary policy by increasing the target range for the federal funds rate by $\frac{1}{4}$ of 1 percent to $5\frac{1}{2}$ percent in March 1997. The fiscal deficit was brought down to 1.4 percent of GDP in 1996, compared with 3.6 percent in 1993, and an agreement was reached on a fiscal framework that will achieve fiscal balance by 2002.

Japan

The Board concluded the Article IV consultation with Japan in July 1996. The pace of recovery after the bursting of the asset price bubble in 1990–91 had picked up since mid-1995 (Table 5), with real GDP growth reaching 3.0 percent in the first quarter of 1996 and averaging $6\frac{1}{2}$ percent annually in the three quarters since mid-1995. This marked acceleration

resulted from a strengthening in all major components of domestic demand. The unemployment rate rose to a historic peak of almost $3\frac{1}{2}$ percent in late 1995, but other indicators suggested the beginning of a turnaround in labor market conditions.

After mild deflationary pressures in 1995, consumer prices started to rise slightly in the first half of 1996, owing more to the pass-through effects of yen depreciation than to tighter market conditions. Most indicators pointed to continuing large margins of slack in output and labor markets. Consumer spending increased only modestly through 1995 but jumped by $2\frac{1}{2}$ percent in the first quarter of 1996. More recent consumption data suggested that the surge in activity in the first quarter was a temporary phenomenon, as did data on public and residential investment, industrial production, and employment.

From mid-1995, as interest rates dropped and the yen fell back, monetary conditions eased substantially. Growth in broad money (M3) remained stable at about 4 percent, but lower interest rates caused a shift to more liquid deposits and cash, causing growth in M2 plus certificates of deposit (CDs) to increase to about 3 percent, while growth in M1 jumped to over 15 percent. After remaining flat in 1994, growth of both domestic credit and bank lending resumed in 1995. The shift of deposits from banks to the postal savings system continued, with the ratio of postal savings to M2 plus CDs reaching almost 40 percent.

The general government budget position (excluding social security) deteriorated from approximate balance in fiscal year 1990 to a deficit of $6\frac{1}{2}$ percent of GDP in fiscal year 1995, mostly as a result of weak cyclical conditions on revenues and a reversal of the temporary surge in revenues from the asset price bubble. The deterioration in economic conditions in early 1995 led the authorities to introduce an economic stimulus package in September 1995, providing for ¥8 trillion in public investment, and the extension of an income tax cut for another year. Thus, substantial fiscal support was in place for fiscal year 1996.

Nominal and real external balances fell sharply in the face of the drop in the real effective value of the yen after mid-1995 to close to historical trends. Declines in the external balance were explained in part by the strong growth in domestic demand and by structural changes in trade patterns. Real net exports dropped sharply, and manufactured imports grew much more strongly than might have been expected. Both exports and imports were affected by the further outsourcing of domestic production.

In their discussion, Directors welcomed signs that Japan was finally entering a phase of recovery, partly as a result of the decisive stimulus measure taken the previous year and the reversal of the overvaluation of the

yen. Most Directors believed that this reversal had returned the exchange rate to a level broadly in line with the fundamentals. Directors considered that the recent surge in GDP growth probably overstated the underlying strength of activity. At the same time, the continued large output gap, higher-than-usual unemployment, and the absence of wage and price pressures suggested that there was little immediate danger of economic overheating, and Directors concluded that the current policy stance should be maintained for the time being and reassessed later in the year. In the longer run, a range of structural reforms would be necessary to increase efficiency and ensure durable growth.

As regards fiscal policy, Directors agreed that past stimulus packages continued to provide desirable support to economic activity. However, the fiscal position had deteriorated sharply since the collapse of the bubble economy, and there had been a substantial increase in public debt. Most Directors emphasized that the exceptional fiscal stimulus through recent measures should be phased out in 1997 if the recovery continued as envisaged. However, some Directors noted that, given the historically high rate of unemployment and downside risks to the economic outlook, there may be a need to continue fiscal support measures—particularly if activity were to weaken later in the year. Directors expressed concern about the deterioration in Japan's longer-run fiscal situation, noting the significant challenges posed by the country's aging population. They noted the desirability of taking decisive and forward-looking actions to put the fiscal situation on a sustainable footing, and they welcomed the authorities' intention to place fiscal consolidation in a medium-term framework.

Monetary conditions were at the easiest levels since the start of the recession, Directors noted. Given that the margins of slack were large and inflationary pressures were negligible, Directors generally concluded that the current accommodative monetary stance was appropriate and should be maintained until there were clear signs that the economy was on an autonomous recovery path. Some Directors mentioned the desirabil-

ity of strengthening the independence of monetary policymakers, noting that such steps would facilitate setting longer-term objectives for policy.

Directors welcomed the authorities' changed approach over the past year in dealing with strains in the financial sector. Restoring strength and confidence in the financial sector would take time, and they considered that the passage of legislation to deal with the *jusen* problem (the insolvency of several housing loan companies) was an important step toward reducing uncertainties. Nevertheless, many Directors expressed concern about the lack of transparency in the approach taken to resolving the *jusen* problem and emphasized the need for a clearly defined and comprehensive plan to resolve remaining difficulties that did not rely on further ad hoc solutions.

Table 5
Japan: Selected Economic Indicators
(Data as of Board discussion in July 1996)¹

	1993	1994	1995	1996	
				Projections at time of Board discussion	Outturn ²
<i>In percent</i>					
Domestic economy					
Change in real GDP	0.1	0.5	0.9	3.4	3.6
Unemployment rate	2.5	2.9	3.1	3.3	3.4
Change in consumer prices (period average)	1.3	0.7	-0.1	0.2	0.1
<i>In billions of U.S. dollars¹</i>					
External economy					
Exports, f.o.b.	352.9	386.0	429.4	420.6	400.2
Imports, f.o.b.	213.3	241.5	297.2	327.8	316.7
Current account balance	132.0	130.6	111.4	69.5	66.0
Direct investment	-13.7	-17.2	-22.7	-23.3	23.5
Portfolio investment	-70.7	-26.7	-36.2	-43.6	-43.6
Capital account balance	-1.5	-1.9	-2.3	-0.2	-0.2
Gross official reserves ³	98.5	125.9	183.2	216.6	216.6
Current account balance (in percent of GDP)	3.1	2.8	2.2	1.5	1.4
Change in real effective exchange rate (in percent)	22.1	7.6	5.7	-13.3	-14.8
<i>In percent of GDP¹</i>					
Financial variables					
General government balance	-1.6	-2.1	-3.1	-4.0	-4.6
General government balance (excluding social security)	-4.8	-5.0	-5.9	-6.8	-7.3
Gross national saving	32.8	31.5	30.8	31.1	31.2
Gross national investment	29.7	28.7	28.7	29.9	29.8
Change in broad money (M3; in percent)	3.9	4.0	3.6	...	...
Three-month CD rate (average; in percent)	2.8	2.1	2.1	...	...

¹Unless otherwise noted.

²Updated Fund staff estimates.

³Excluding gold.

Table 6

Germany: Selected Economic Indicators*(Data as of Board discussion in September 1996)¹*

	1993	1994	1995	1996	
				Projections at time of Board discussion	Outturn ²
<i>In percent</i>					
Domestic economy					
Change in real GDP	-1.2	2.9	1.9	1.0	1.4
Unemployment rate	8.9	9.6	9.4	10.3	10.3
Change in consumer prices (period average)	4.5	2.7	1.8	1.6	1.5
<i>In billions of U.S. dollars¹</i>					
External economy					
Exports, f.o.b.	445.0	493.3	588.1	594.5	604.2
Imports, f.o.b.	436.6	481.9	563.5	558.1	574.4
Current account balance	-16.0	-21.8	-17.3	-10.9	-17.1
Direct investment	-15.3	-16.7	-34.9	...	-30.5
Portfolio investment	119.4	-33.2	26.7	...	50.9
Capital account balance	0.5	0.2	-0.7	...	11.9
Gross official reserves	14.2	2.0	-7.2	...	-1.3
Current account balance (in percent of GDP)	-0.9	-1.0	-0.7	-0.5	-0.7
Change in real effective exchange rate (in percent)	8.0	2.2	7.9	...	-0.6
<i>In percent of GDP¹</i>					
Financial variables					
General government balance	-3.5	-2.6	-3.5	-4.0	-3.8
Primary structural balance ³	0.8	1.7	0.9	1.4	1.2
Gross national saving	20.6	21.7	21.7	20.8	20.7
Gross national investment	21.4	22.7	22.4	21.3	21.5
Change in broad money (M3; annual average; in percent)	8.2	8.5	0.1	6.5 ⁴	7.5
Three-month interbank rate (in percent)	7.2	5.3	4.5	3.3 ⁵	3.3

¹Unless otherwise noted.²Updated Fund staff estimates.³General government balances for 1995 and 1996 were affected by the incorporation of previously off-budget (primarily interest) expenditures, so that changes in the primary structural balance—which is the budgetary position, excluding interest transactions, that would be observed if the level of actual output coincided with potential output—are a better measure of the fiscal impulse.⁴Average January–May 1996 compared with average January–May 1995.⁵Average January–June 1996.

Directors underscored the key role of structural adjustment in medium- and long-term growth prospects. In the view of a number of Directors, this constituted the authorities' main policy challenge, and they urged the Japanese authorities to accelerate efforts to deregulate the economy, including reforming the labor sector and implementing reforms relating to land use and the telecommunications sector. Aggressively pushing ahead with such policies would enhance Japan's welfare and would benefit the international community. They commended Japan's role as the world's largest provider of financial assistance to developing countries and welcomed Japan's generous sup-

port for the ESAF and the Fund's technical assistance activities.

Since the consultation, the Japanese authorities have completed the introduction of procedures and other measures to be taken in the case of the failure of financial institutions. Also, the Bank of Japan Law has been revised with a view to strengthening the independence of the central bank.

Germany

The Board concluded the Article IV consultation with Germany in September 1996. Real GDP, after growing during 1994 and the first half of 1995 at almost 3 percent, stalled in the second half of 1995, for an annual increase of only 1.9 percent (Table 6). In the first quarter of 1996, real GDP contracted slightly. Private consumption continued its moderate (0.5 percent quarterly) growth rate. Unemployment had reached its highest postwar level in March 1996, at 10.4 percent, before edging down to 10.3 percent in June.

Consumer prices rose by only 1¾ percent in 1995, owing to the strength of the deutsche mark, competitive pressures on traded goods, and weakness of domestic demand. In the first half of 1996 consumer prices rose only 1½ percent over the corresponding period in 1995, while wholesale, producer, and import prices fell.

Government deficits for 1995 and 1996 were substantially greater than expected and exceeded the Maastricht reference values. Efforts

to correct the fiscal imbalances induced by unification experienced an unexpected setback in 1995, when the general government deficit increased by nearly 1 percentage point to 3½ percent of GDP. Despite expenditure restraints, the federal deficit was projected to rise further, by almost ½ of 1 percentage point of GDP, in 1996 because of an unanticipated revenue shortfall, which resulted from unusually large lagged effects on tax receipts from the 1992–93 recession and the extensive use of special tax allowances for investment in eastern Germany and in housing.

Broad money (M3) grew by only 2.7 percent in 1995 compared with the average in the fourth quarter

of 1994, falling short of the target range of 4–6 percent, but the annualized six-month growth rate for M3 reached 6 percent by December; by June 1996, M3 was growing at an annual rate of 9.3 percent over the fourth quarter of 1995. The authorities lowered the discount and Lombard rates by a total of 150 basis points during 1995 to 3 percent and 5 percent, respectively, by end-1995, and short-term market interest rates dropped in concert with the official rates. Despite rapid M3 growth, the Bundesbank lowered the discount and Lombard rates again in April, bringing them to historical lows. This reflected the authorities' approach of taking a wide array of real, financial, and international indicators into account in gauging the appropriateness of monetary conditions. The lowering of rates by the Bundesbank signaled the Bundesbank's view that rates could drop in the market; the repurchase rate, however, was kept unchanged at 3.3 percent until August 1996. Long-term rates have been volatile.

Since the end of 1995, the deutsche mark had weakened against the U.S. dollar and many European currencies outside the exchange rate mechanism (ERM) of the European Monetary System (EMS)—in particular, the lira and pound sterling—depreciating by 3½ percent in nominal effective terms by June 1996. However, turbulence in the U.S. stock market meant that the dollar slipped by 2 percent vis-à-vis the deutsche mark in July.

In their discussion, Directors welcomed the projected rebound in economic activity after the significant weakening in 1995 but noted that there was still some way to go before a robust recovery might take hold. They were encouraged by the more moderate wage settlements in the current year, which would help to enhance Germany's weakened cost competitiveness. However, comprehensive action on both the macroeconomic and the structural fronts was necessary to improve the fundamentals, reduce reliance on regulations and subsidies, enhance confidence, and reduce unemployment.

Directors noted that prudent monetary policy in the past few years had restored low inflation; in the current circumstances, they welcomed the more recent relaxation of monetary conditions. They warmly commended the recent lowering of the repurchase rate, which would lessen the downside risks to growth, particularly in view of the sizable fiscal retrenchment taking place simultaneously in Germany and its major European trading partners. Some Directors emphasized the need for continued close attention to monetary policy given Germany's anchor function in the ERM.

Directors supported the authorities' package of fiscal measures and structural reforms and urged that it be fully implemented. They considered the package an appropriate response to the challenges posed by both

the domestic economy and the move toward Economic and Monetary Union (EMU) in Europe. However, Directors were of the view that, if growth were lower than projected, fiscal policy should continue to be anchored by medium-term structural goals. Directors supported the authorities' medium-term fiscal objectives, including further consolidation efforts, a return of expenditures as a share of GDP to the preunification level, and a lowering of the heavy tax-cum-social contribution burden.

Directors observed that the high unemployment rate continued to be Germany's most pressing economic issue, and they stressed the need for significant structural reforms to realize the labor market flexibility required to achieve lasting reductions in unemployment. Major structural reform was needed in the goods and services markets, the health and pension systems, and the labor market. The authorities were in the early stages of addressing those issues, and Directors encouraged them to persevere in making the economy more flexible and competitive.

Directors noted the significant progress achieved in the past five years in integrating the new Länder into the German market economy, but they stressed that serious challenges remained, including the imbalance between saving and investment in the east, the severe labor cost disadvantage in the new Länder, and the public transfers and subsidies from the west that risked promoting an entitlement culture and distorting resource allocation.

Several Directors commended the authorities on their significant assistance to economies in transition, but it was hoped that the decline in official development assistance observed in the preceding few years would be reversed.

France

The Board concluded the Article IV consultation with France in October 1996. Economic performance in 1995 fell substantially short of expectations, with an overall growth in real GDP of 2¼ percent (Table 7). Production recovered in early 1996 following the end of widespread strikes in November and December 1995, with output leveling off in the second quarter of 1996. Unemployment edged down to 11½ percent in 1995 but was back to the record high of 12½ percent by mid-1996. Underlying inflation in 1995 was lower than the recorded 2 percent rise in consumer prices—and remained low through June 1996.

In 1995 the government took measures to correct the incipient fiscal slippage and to initiate a far-reaching reform of social security. These were important steps forward in tackling the economy's structural fiscal problem and improving the prospects for meeting the criteria of EMU on the planned timetable. The fiscal reforms kept the deficit to the targeted 5 percent of

Table 7

France: Selected Economic Indicators*(Data as of Board discussion in October 1996)¹*

	1993	1994	1995	1996	
				Projections at time of Board discussion	Outturn ²
<i>In percent</i>					
Domestic economy					
Change in real GDP	-1.3	2.8	2.2	1.3	1.5
Unemployment rate	11.6	12.3	11.6	12.4	12.4
Change in consumer prices (end of period)	2.1	1.6	2.1	1.8	1.7
<i>In billions of U.S. dollars¹</i>					
External economy					
Exports, f.o.b.	196.3	221.6	267.5	271.5	270.5
Imports, f.o.b.	189.4	216.2	258.0	257.5	257.3
Current account balance	9.2	7.0	16.6	22.3	21.2
Direct investment	0.3	-6.3	5.0	...	-4.4
Portfolio investment	3.0	-55.8	-13.5	...	-60.9
Capital account balance	-11.8	-11.1	-21.3	...	-20.1
Gross official reserves	22.6	26.3	26.9	...	26.8
Current account balance (in percent of GDP)	0.7	0.6	1.2	1.4	1.4
Change in real effective exchange rate (in percent)	2.1	0.0	0.4	-1.1 ³	-1.9
<i>In percent of GDP¹</i>					
Financial variables					
General government balance	-5.8	-5.8	-5.0	-4.0	-4.2
Gross national saving	18.2	19.0	19.8	19.1	18.8
Gross national investment ⁴	17.2	18.4	18.3	17.5	17.1
Change in broad money (M3; in percent)	-3.2	1.7	4.7	0.6 ³	-1.5
Three-month interbank rate (period average; in percent)	8.4	5.8	6.6	4.0 ⁵	3.9

¹Unless otherwise noted.²Updated Fund staff estimates.³Second quarter over same period in 1995.⁴Stockbuilding included.⁵Average to September 18, 1996.

GDP, which contrasted positively with the outturn in the previous four years. For 1996, the government announced a ceiling on the fiscal deficit of 4 percent of GDP, which put French fiscal policy on course to meet the Maastricht target of 3 percent for 1997.

As regards monetary policy, the Bank of France had managed since the fall of 1995 to bring the franc back within the former narrow band of the EMS and to narrow interest rate differentials with Germany. Overall, the return of market confidence contributed to a substantial easing in monetary conditions.

Exports weakened markedly during the second half of 1995, but with domestic demand relatively subdued the current account surplus reached about 1¼ percent of GDP in 1995. Total official reserves (excluding gold) increased slightly, to \$27 billion. The fiscal

reform packages played a critical role in the strengthening of the franc.

In their discussion, Directors commended the authorities for the progress they had made in fiscal consolidation, their maintenance of a prudent monetary policy, and their strong commitment to further fiscal consolidation and first-round participation in EMU—policies that had been rewarded by a striking improvement in financial market conditions. However, economic activity had been weaker than expected, and some uncertainty clouded the outlook for 1997.

As regards fiscal policy, Directors felt it was still possible to hold the deficit in 1996 to the targeted 4 percent of GDP if economic recovery was on track. However, they were concerned about slippages in cutting back the social security deficit and noted the risks of further overruns in health care spending. Directors welcomed the announcement of a budget for 1997 designed to respect the Maastricht reference value of 3 percent of GDP, although they noted that the budget contained little margin for unexpected adverse developments. They also noted that the decline in the 1997 deficit was due in large part to a one-off transfer

from a public enterprise. They urged the authorities to implement additional measures beginning in early 1997 to ensure adequate structural adjustment and to avoid an increase in the deficit, in the event of weaker-than-expected activity, that could jeopardize market confidence in the achievement of EMU. France faced serious pressure on the public finances from demographic changes in the long term, and the fiscal deficit should therefore be reduced to close to balance over the next few years. The level of public spending was clearly too high.

Directors welcomed the skillful handling of monetary and exchange rate policy. Inflation remained low, and the reduction of interest rates reflected the credibility of both monetary and fiscal policy. Directors supported the cautious approach of the Bank of France to

further monetary easing and the priority attached to sustaining the stable and favorable monetary environment.

Directors were concerned about the record level of unemployment, which was due in large part to structural problems in the labor market. Far-reaching reforms were needed to cut unemployment, which was both a serious social problem and a potential threat to the credibility of fiscal adjustment.

Directors urged the authorities to strengthen their efforts to address the problems in state-owned banks. The authorities should proceed rapidly with privatization, remove distortions and establish a more level playing field, strengthen supervision, and improve corporate governance and internal controls. They also pressed for progress with privatization and reforms in other sectors where the state was involved in commercial activities.

Directors praised France's traditionally generous commitment to development assistance, and they urged the authorities to maintain aid flows, which had suffered from budgetary stringency, at as high a level as possible.

United Kingdom

The Board concluded the Article IV consultation with the United Kingdom in October 1996. Real GDP growth slowed to about 2 percent a year through the second quarter of 1996 as economic slowdowns in the United Kingdom's trading partners affected net exports (Table 8). Weak demand meant overhanging stocks, which translated into output cuts that further harmed growth, and the beef crisis adversely affected agricultural output. The unexpected weakness of output and its uncertain duration caused sluggish private fixed investment. Nonetheless, unemployment fell to a five-year low of 7½ percent in July 1996 (2 percent below the European Union average), thanks in part to active policies against long-term unemployment.

Inflation was contained despite sharp increases in 1995 in input costs associated with sterling's depreciation and a surge in commodity prices. Factors contributing to subdued inflation included moderate economic expansion with a continuing output gap, increased com-

petition associated with a structural change in retailing, and pricing policies for privatized utilities.

Following initial successes, the fiscal consolidation effort was marred by slippages. The public sector borrowing requirement for 1995/96 was 4.9 percent of GDP, compared with 3.4 percent projected in the November 1994 budget. Revenues were responsible for about four-fifths of the slippage; nominal expenditures were successfully kept within the established targets, although real expenditures were somewhat higher because of lower-than-expected inflation. The November 1995 budget measures were broadly neutral; income tax reductions of about ½ of 1 percent of GDP were roughly offset by cuts in current and capital spending.

In line with the medium-term monetary policy framework, official interest rates were raised in several

Table 8

United Kingdom: Selected Economic Indicators

(Data as of Board discussion in October 1996)¹

	1993	1994	1995	1996	
				Projections at time of Board discussion	Outturn ²
<i>In percent</i>					
Domestic economy					
Change in real GDP	2.1	3.8	2.5	2.2	2.1
Unemployment rate	10.3	9.3	8.2	7.6	7.5
Change in consumer prices (period average) ³	3.0	2.4	2.8	2.8	2.9
<i>In billions of U.S. dollars¹</i>					
External economy					
Exports, c.i.f.	182.3	206.3	240.5	251.0	259.4
Imports, f.o.b.	202.6	222.8	258.8	273.2	278.5
Current account balance	-16.2	-3.7	-6.2	-1.8	0.0
Direct investment	-10.1	-17.7	-8.0	...	-10.9
Portfolio investment	-59.1	77.5	-37.0	...	-48.0
Capital account balance	19.6	-4.1	0.7	...	-4.6
Gross official reserves	43.6	43.0	50.1	42.7	42.7
Current account balance (in percent of GDP)	-1.7	-0.4	-0.6	-0.2	0.0
Change in real effective exchange rate (in percent)	-8.2	-0.8	-4.3	3.8	3.3
<i>In percent of GDP¹</i>					
Financial variables					
General government balance	-7.8	-6.8	-5.5	...	-4.4
Gross national saving	13.7	15.7	15.8	...	16.1
Gross national investment	15.0	15.4	15.6	...	15.3
Change in broad money (M4; in percent)	4.9	4.0	9.9	9.4	9.5
Three-month interbank rate (period average; in percent)	5.9	5.5	6.7	6.0	6.0

¹Unless otherwise noted.

²Updated Fund staff estimates.

³Excludes mortgage interest payments.

steps in late 1994 and early 1995, but once growth slowed and inflation prospects improved official rates were lowered between December 1995 and June 1996 by a total of 1 percentage point in four steps. Monetary conditions eased considerably as a result of the depreciation of sterling in early 1995. Monetary aggregates expanded quite rapidly, with growth of sterling M4 rising to nearly 10 percent. Credit expansion was also strong. There was limited progress in strengthening policy credibility, as revealed by yields on indexed government securities and long-term interest rate differentials with Germany.

The external current account remained near balance, with rising surpluses on services and oil trade offsetting a decline in non-oil trade. External competitiveness was favorable by past standards.

In their discussion, Directors welcomed the United Kingdom's recent economic performance, which was especially noteworthy given the sluggish activity elsewhere in Europe. Directors noted that prospects for 1997 were positive, with growth likely to strengthen, unemployment to decline further, and inflationary pressures to remain subdued. Directors emphasized the importance, in achieving this performance, of sound policy that emphasized medium-term stability, fiscal consolidation, and flexible markets.

Nevertheless, Directors noted the need to enhance the credibility of the authorities' policy commitment, especially in the fiscal area, and therefore considered that the fiscal imbalances were too large and that further consolidation was required. Directors observed that the ratio of current expenditure to GDP had risen in recent years, despite the significant decline in the unemployment rate. They suggested that current outlays bear the brunt of additional fiscal cuts, keeping in mind the potential effect on income distribution. Many Directors considered that there was no scope for further tax cuts in the upcoming budget. Steps should be taken to bolster the revenue-generating capability of the tax system, including by reducing exemptions and preferences.

A number of Directors considered that credibility could be strengthened by increasing central bank independence. Directors observed that the inflation-targeting framework for monetary policy had delivered impressive results. They generally cautioned against further reductions in short-term interest rates.

Board members welcomed the United Kingdom's continued active involvement in discussions on preparations for EMU in Europe, and the authorities' view that the economic criteria under the Maastricht Treaty were highly desirable objectives for U.K. policy, whether or not the country eventually decided to join the monetary union.

The United Kingdom's structural policies—notably privatization, labor market reforms, and deregulation—

had contributed in important ways to improving economic performance and prospects, in the Board's view. Combined with macroeconomic policies geared to medium-term stability, these structural reforms should provide a basis for improving growth performance in the medium term.

Directors noted the likelihood that official development assistance, which was at a level of 0.3 percent of GNP, was set to decline even further, and they encouraged the authorities to raise it.

Italy

Directors met in April 1997 to conclude the 1996 Article IV consultation with Italy, against the background of a sharp decline in inflation but a weak economic recovery (Table 9). GDP growth was estimated at 0.7 percent and unemployment at about 12 percent in 1996. Inflation (year-on-year) was more than halved from 6 percent in November 1995 to slightly over 2 percent in early 1997, with the official target for 1997 (2½ percent) set to be achieved.

The current account balance improved strongly in 1996: although export growth decelerated sharply as from late 1995, the slowdown in domestic demand also made for a marked fall in imports. Aided also by an improvement in the terms of trade, the trade surplus widened to close to 5 percent of GDP.

The notable progress in reducing the fiscal imbalance in 1992–95 stalled in 1996, with the general government deficit amounting to an estimated 6.7 percent of GDP, above official objectives. The overrun from the original deficit target was primarily due to considerably weaker growth, as well as the underlying dynamics of primary current spending.

For 1997, the government set the objective of joining EMU from the start, and it presented a budget aimed at achieving a general government deficit of 3 percent of GDP. In early 1997, the authorities estimated that, in the absence of additional measures, the general government deficit target would be missed. Against this background, on March 27 the government introduced a corrective fiscal package (in an amount of 0.8 percent of GDP), with a view to achieving the Maastricht deficit criterion, and announced the start of negotiations with the social partners on a reform of the welfare system.

The authorities continued to pursue a tight monetary policy, geared to reducing inflation. With progress on the latter front, official rates were gradually reduced, bringing the discount rate to 6¾ percent after the latest reduction in January 1997. Long-term interest rates declined sharply over the past year, to a level consistent with the Maastricht interest rate criterion. By January 1997, long-term differentials with Germany had reached a low of under 150 basis points, although they widened somewhat thereafter

in the face of market uncertainties regarding the EMU process. The improved inflation performance and relatively high money market rates helped to foster the appreciation of the exchange rate. By the fall of 1996, the authorities judged the lira to have strengthened sufficiently and on a durable basis to justify ERM reentry, and the lira rejoined the ERM in November.

In their discussion, Directors commended the significant progress that Italy had made since 1992 toward price stability, fiscal consolidation, and strengthened external accounts. That progress had placed the country in a position to aspire to participate in EMU from the start, and had been rewarded by increased market confidence. Directors particularly welcomed the remarkable decline in inflation, aided by wage moderation and the authorities' firm conduct of monetary policy.

At the same time, Directors emphasized that Italy faced several key challenges, including a slow economic recovery, relatively inflexible labor markets, high unemployment concentrated in the south, and the need to achieve sustained structural strengthening of public finances. On the labor market, Directors welcomed the positive aspects of the recent Pact for Employment but stressed the need for bolder initiatives toward labor market flexibility, in particular through greater regional and sectoral wage differentiation and a wider use of nontraditional work contracts.

Given its high public debt and interest rate premiums, Italy had much to gain from participation in EMU. However, it faced the difficult task of having to effect the largest fiscal correction among early EMU contenders in the context of a weak economic outlook. Directors commended the authorities' decision to step up the pace of fiscal adjustment in 1997. However, while the corrective fiscal package of March 1997 would bring the deficit within reach of the Maastricht reference value in 1997, Directors noted that the reliance on revenue and one-off measures raised questions about the sustainability of fiscal adjustment beyond 1997. Permanent savings in such key spending areas as pensions, health, and public employment were critical. Directors welcomed the government's intention to rely on structural measures in the 1998 budget

Table 9
Italy: Selected Economic Indicators
(Data as of Board discussion in April 1997)

	1993	1994	1995	1996 ¹
	<i>In percent</i>			
Domestic economy				
Change in real GDP	-1.2	2.1	3.0	0.7
Unemployment rate ²	10.2	11.3	12.0	12.1
Change in consumer prices (end of period)	4.3	4.0	5.6	2.6
	<i>In billions of U.S. dollars³</i>			
External economy				
Exports, f.o.b.	226.8	250.3	298.9	329.9
Imports, f.o.b.	192.7	212.9	253.5	266.3
Current account balance	11.4	15.1	27.2	42.3
Direct investment	-3.5	-2.9	-0.9	-3.4
Portfolio investment	72.6	-5.1	30.3	41.6
Capital account balance	9.5	-13.8	-4.0	-5.1
Gross official reserves	53.7	56.7	55.8	69.4
Current account balance (in percent of GDP)	1.1	1.5	2.5	3.5
Change in real effective exchange rate (in percent)	-16.2	-6.3	-8.0	10.4
	<i>In percent of GDP³</i>			
Financial variables				
General government balance	-10.0	-9.6	-7.0	-6.7
Gross national saving	18.1	18.9	20.6	21.1
Gross national investment	16.9	17.1	18.1	17.8
Change in M2 (in percent) ⁴	7.8	1.7	2.1	2.7
Three-month rate on treasury bills (period average; in percent)	10.5	8.8	10.7	8.6

¹Fund staff estimates.

²Excluding workers in the Wage Supplementation Fund.

³Unless otherwise noted.

⁴End of period, moving average of last three months; growth rate used for target monitoring.

and the announcement of the imminent start of discussions on the reform of social spending.

Directors noted that monetary union, with the intensified competitive pressures that it would bring, would increase the challenges faced by the Italian banking system. Directors recognized that current problems had both important cyclical and regional components, but they stressed the importance of continuing to address the problems of nonperforming loans, overstaffing, and high operating costs. Accelerated privatization of the major banks was seen as crucial to addressing the banking sector's structural problems.

Canada

The Board concluded the Article IV consultation with Canada in January 1997. Canada has had considerable success in the implementation of its economic strategy. In fiscal year 1996/97 (ending March 1997) the federal budget deficit was expected to be below the target of 3 percent of GDP. This was being accomplished by

Table 10

Canada: Selected Economic Indicators*(Data as of Board discussion in January 1997)*

	1993	1994	1995	1996 ¹
	<i>In percent</i>			
Domestic economy				
Change in real GDP	2.2	4.1	2.3	1.4
Unemployment rate	11.2	10.4	9.5	9.7
Change in consumer prices (end of period)	1.7	0.1	1.8	1.6
	<i>In billions of U.S. dollars²</i>			
External economy				
Exports, f.o.b.	161.9	183.1	212.3	226.5
Imports, f.o.b.	164.4	179.9	198.3	206.4
Current account balance	-22.3	-16.2	-8.2	0.3
Direct investment	-0.8	-0.2	5.0	...
Portfolio investment	21.0	9.0	14.7	...
Capital account balance	29.4	14.3	4.4	...
Gross official reserves	12.1	13.1	15.3	...
Current account balance (in percent of GDP)	-4.0	-3.0	-1.4	0.0
Change in real effective exchange rate (in percent)	-3.3	-6.7	-3.9	...
	<i>In percent of GDP²</i>			
Financial variables				
General government balance	-7.3	-5.3	-4.1	-2.1
Gross national saving	13.6	15.3	17.0	17.5
Gross national investment	18.2	19.0	18.2	17.5
Change in broad money (in percent)	3.1	2.7	4.0	2.3
Three-month treasury bill rate (in percent)	4.8	5.5	7.0	4.2

¹Fund staff projections.²Unless otherwise noted.

measures introduced in the 1994, 1995, and 1996 budgets, which cut business and farm subsidies, commercialized public spending programs, imposed user charges, and lowered government consumption by scaling back most spending programs, cutting defense spending, and eliminating some 55,000 government jobs.

Real GDP growth picked up in 1996, from 0.7 percent during 1995 (fourth quarter to fourth quarter) to an annual rate of 1.3 percent during the first half of 1996 and 3.3 percent in the third quarter, led by increases in residential construction and investment in machinery and equipment. Personal consumption increased sharply in the first quarter of 1996 but rose moderately during the second and third quarters. The unemployment rate remained at about 9½ percent during the first half of 1996, but then rose slightly to 9.7 percent in December (Table 10).

Core consumer price inflation fell from 4.6 percent in 1989 to less than 2 percent at the beginning of 1996. It dropped further to 1.7 percent during the first 11 months of 1996, reflecting the slack in the economy.

Monetary conditions eased significantly in 1995 and 1996. The Bank of Canada's operating band for

the overnight interest rate was reduced in steps from 5½–6 percent in early January to 2¾–3¼ percent in November. Canadian short-term interest rates have been below their U.S. counterparts since March 1996—unprecedented in recent decades—while differentials between Canadian and U.S. long-term interest rates narrowed sharply to levels well below the historical average. This reflects Canada's sustained low inflation and the steady progress in reducing the federal budget deficit.

The external current account deficit was 1.4 percent of GDP in 1995 and continued to improve during 1996, shifting into small surpluses in the second and third quarters. This improvement was largely due to the strength of the U.S. economy, and to the lagged effects of the real effective depreciation of the Canadian dollar in the early 1990s.

Canada experienced large net inflows of direct investment and portfolio capital in 1995 and the first three quarters of 1996, while at the same time large short-term outflows by Canadian banks and sales of money market instruments were recorded.

In their discussion, Directors commended the authorities for the impressive progress in implementing their economic strategy during the past year. They noted that inflation had been contained at a low level, federal fiscal deficit targets were being more than met, and substantial measures had been taken by provincial governments to balance their budgets. Sound macroeconomic policies had improved confidence in financial markets, as reflected in the negative short-term Canada–U.S. interest rate spreads. This considerable progress in the economic fundamentals had improved Canada's prospects for sustainable growth.

Directors agreed that the easing in monetary conditions during 1996 had been appropriate in light of the sustained low inflation, strong fiscal adjustment at all levels of government, and considerable slack in the economy. Caution would have to be exercised in easing monetary conditions further, however, given the considerable stimulus from past policy actions and the lags between monetary policy actions and their effects on the economy. Directors noted that strong output growth in the third quarter of 1996 and the economic

indicators for the fourth quarter seemed to signal the long-awaited strengthening of economic activity in Canada.

Directors were encouraged by the plans to eliminate fiscal imbalances at the federal and provincial levels during the next few years. They noted the quality of the fiscal adjustment, which relied mainly on expenditure cuts rather than revenue increases. It was important that the government hold to its planned fiscal policy course set out in the 1995 and 1996 federal budgets to achieve the deficit-reduction targets for the coming years. Those measures might balance the budget by 1999/2000.

Directors remained concerned by the persistence of high unemployment rates. They also observed that the public old-age support system faced important challenges, given the aging population in Canada and the large unfunded liability of the system. They commended the authorities' initiatives in facing those challenges and urged the federal and provincial authorities to reach agreement quickly on an appropriately balanced package of contribution rate increases and benefit cuts to shore up the finances of the Canada Pension Plan. Subsequent to the Board discussion, agreement was reached between the federal and provincial governments on measures to deal with the long-term needs of the Plan.

Directors commended Canada's consistent support for free trade, including multilateral trade liberalization and regional and bilateral market opening on terms supportive of the multilateral trading system. They supported the further reduction of tariffs on a range of goods and the simplification of Canada's tariff system.

Directors were encouraged by Canada's commitment to raise its official development assistance, as circumstances allowed, toward the target of 0.7 percent of GNP.

Other Advanced Economies

Greece

The Board concluded the Article IV consultation with Greece in August 1996. Greece's economic performance had improved during 1995 as output growth accelerated to 2 percent, although unemployment rose

Table 11

Greece: Selected Economic Indicators

(Data as of Board discussion in August 1996)

	1993	1994	1995	1996 ¹
	<i>In percent</i>			
Domestic economy				
Change in real GDP	-1.0	1.5	2.0	2.5
Unemployment rate	9.7	9.6	10.0	9.8
Change in consumer prices (end of period)	12.1	10.8	8.1	5.0
	<i>In billions of U.S. dollars²</i>			
External economy				
Exports, f.o.b.	5.0	5.2	5.8	...
Imports, c.i.f.	17.6	18.7	22.9	...
Current account balance	-0.7	-0.1	-2.9	...
Capital account balance	4.4	6.9	3.1	...
Gross official reserves	8.6	15.3	15.7	...
Current account balance (in percent of GDP)	-0.4	0.2	-1.5	-1.8
Change in real effective exchange rate (in percent)	-3.6	1.3	3.7	...
	<i>In percent of GDP²</i>			
Financial variables				
General government balance	-14.2	-12.1	-9.2	-7.0
Gross national saving	21.1	21.0	20.3	21.0
Gross national investment	21.5	20.8	21.8	22.8
Change in broad money (in percent)	15.3	13.9	8.3	9-12
Three-month treasury bill rate (in percent)	18.2	18.2	14.5	...

¹Fund staff estimates.

²Unless otherwise noted.

slightly to 10 percent during the year (Table 11). Inflation dropped below two digits in 1995 for the first time in two decades.

There was further progress in fiscal consolidation, with the central government deficit declining from 12.7 percent of GDP in 1994 to 11.2 percent in 1995, against a budget target of 10 percent. The overrun was due mainly to revenue shortfalls, particularly in indirect taxes, and to delays in transfers from the European Union. However, the authorities met the convergence plan target for the general government deficit. Monetary policy continued to be guided by the preannounced exchange rate target. The target for the rate of crawl of the drachma vis-à-vis the European currency unit (ECU) of 3 percent during 1995 was achieved. This policy and the successful handling of a speculative attack against the drachma in May 1994 had spurred a surge in capital inflows. The Bank of Greece adopted a cautious stance in dealing with the inflows—lowering intervention rates only slowly, sterilizing most of the inflows, raising reserve requirements from 9 percent to 11 percent, and extending reserve requirements to short-term foreign currency liabilities of the banking sector.

After two years at near balance, the current account deficit widened in 1995 to 1.5 percent of GDP because of a sharp increase in imports of investment goods. The capital account remained in surplus, although the surplus was smaller than in 1994. Foreign exchange reserves rose slightly.

Against the positive short-term outlook, the macroeconomic framework was showing signs of strain in 1996. Inflation picked up early in the year before resuming a downward trend, the pace of fiscal consolidation slowed, the Bank of Greece was finding it increasingly difficult to use interest rates to contain credit and reduce inflationary pressures, and there were escalating expenditure pressures.

In their discussion, Directors commended the authorities for their continued efforts at fiscal consolidation and inflation reduction. Nevertheless, Directors saw an urgent need to strengthen the adjustment effort.

Directors noted that the budget deficit target for 1996 risked being overshot by about 1 percentage point of GDP and cautioned that such an outcome would represent an unfortunate setback. They welcomed the policy package announced in July 1996, which envisioned reductions in public employment, a review of extrabudgetary accounts, and a strengthening of financial control of public entities. Directors urged the authorities to enact further corrective measures promptly, especially on the expenditure side. They praised the authorities' efforts to expand the tax base but stressed that achievement of lasting fiscal consolidation would require expenditure reduction. Directors expressed concern that the pace of fiscal consolidation had slowed down despite faster-than-projected growth.

Directors noted that the "hard drachma" policy had contributed to reducing inflation in recent years and viewed the authorities' cautious interest policy as appropriate. They pointed out, however, that capital inflows had illustrated the inability of tight monetary policy alone to secure further disinflation in the current policy environment. Directors urged the government to pursue a strict wage and employment policy in the public sector that would serve as a signal to the private sector.

Directors stressed the need to accelerate structural reform to improve Greece's long-term growth performance and to ensure real convergence with Europe. They welcomed the authorities' agenda for structural reform, which included rationalization of public spending, strengthened management of public entities, increased accountability in the public sector, and reform of the unemployment benefits system. They urged the authorities to expand the scope and to accelerate the pace of privatization. Directors also pointed to the need to reduce the state's presence in the banking sector.

Hong Kong, China

Directors met in February 1997 to consider the staff report for the 1996 Article IV consultation discussions with Hong Kong, China⁴ against the backdrop of average annual growth of real GDP of almost 7 percent over the past 15 years. That performance had been achieved in the context of a dramatic change in economic structure, under which the importance of the manufacturing sector and domestic merchandise exports had declined sharply and Hong Kong had emerged as a mature, services-based economy.

Although growth has been slowing since 1994, there were signs in the second half of 1996 of moderate recovery. Retail sales and property prices began to rise, and private construction rebounded. However, merchandise export growth—which usually accompanies the upturn—remained subdued, as export volume rose by only 5 percent in the first nine months of 1996. For the year as a whole, real GDP was projected at the time of the Board discussion to grow by 4½ percent (Table 12). Subsequently, the estimate was revised upward to almost 4¾ percent, the same as the 1995 growth rate. Inflation fell from 8¾ percent in 1995 to about 6 percent in 1996, owing largely to a slowdown in domestic demand, combined with falling import prices resulting from an appreciating exchange rate and some labor market slack. Unemployment, which had risen sharply in 1995 with an expansion of the labor supply, gradually eased to about 2½ percent in 1996.

The Board commended the authorities for successful management of the economy. Directors observed that the key challenge in the near term was to maintain confidence and ensure a smooth transition to Chinese sovereignty. They considered that this could best be achieved by continued adherence to the broadly rules-based policy framework—consisting primarily of the link of the exchange rate to the U.S. dollar, a prudent fiscal policy stance, and firm financial regulation.

Directors fully endorsed continuation of the linked exchange rate system as an important anchor for stability and confidence. They welcomed the Chinese authorities' reaffirmation of their commitment to monetary independence for Hong Kong following the transfer of sovereignty. In light of the different levels of financial development in Hong Kong and the mainland of China, Directors supported the continuation of two separate monetary systems and currencies, as well as two independent monetary authorities. The Board also emphasized the need to continue with a broadly neutral and noninterventionist approach to fiscal policy. Directors considered that continued moderate govern-

⁴During the 1996/97 financial year, Hong Kong was administered by the United Kingdom. It was returned to the People's Republic of China as of July 1, 1997, and became a Special Administrative Region of China.

ment surpluses would be appropriate, given the fiscal implications of an aging population. Directors also commended the authorities for giving priority to maintaining a strong system of banking supervision. They stressed that, given banks' dependence on property lending and the increasing linkages with China's economy, continued close monitoring of asset quality and maintenance of high prudential standards were needed. Directors also welcomed the Hong Kong Monetary Authority's participation in the New Arrangements to Borrow (NAB).

The Board viewed Hong Kong as having strong potential for further high growth over the medium term. They noted that its future lay in developing its services-based export industries and maintaining its status as an international financial center. In this context, they encouraged the authorities to proceed with plans to deregulate the nontraded goods and services markets. Directors also noted that safeguarding Hong Kong's institutions and values, particularly the rule of law, impartiality of the judiciary, neutrality of the civil service, and freedom of information, was important for its medium-term prospects. Directors looked forward to the success of the "one country-two systems" framework and the continued prosperity of the Hong Kong economy.

Israel

The Board concluded the Article IV consultation with Israel in December 1996. The rapid, but fairly balanced, expansion of the Israeli economy since 1989—with GDP rising at more than 6 percent a year—turned into generalized overheating in 1995–96 (Table 13). Underlying inflation accelerated to a rate of 12 percent in mid-1996, from 9 percent in 1994–95, as real wages rose by 2.5 percent in the first half of the year. According to preliminary estimates, domestic demand grew by 5.5 percent, and unemployment rose slightly to some 6½ percent in 1996.

A shift to an expansionary fiscal stance abetted the evolution from growth to overheating. In late 1994, in the wake of what proved to be a transitory rise in revenues, the authorities instituted large increases in public sector wages and simultaneously cut taxes at a cost to the budget of 2.5 percent of GDP. Since then, tax revenues had consistently fallen short of expectations,

and the targets for the domestic deficit had been missed by wide margins. For 1996, the general government budget deficit was estimated at 4.2 percent of GDP.

With fiscal policy easing and the economy overheating, monetary policy turned restrictive after 1994, leading to controversial side effects. The exchange rate strengthened within its crawling band, appreciating about 5 percent in terms of the consumer price index and unit labor costs since 1993. Capital inflows surged, averaging some 2.5 percent of GDP annually during 1995 and 1996. Moreover, domestic financial markets were unsettled by the restrictive monetary policy.

The economy's overheating was particularly evident in the external accounts. The current account deficit increased to more than 5 percent of GDP in 1996, a level not experienced since the early 1980s.

In their discussion, Directors praised authorities for their effective management of the economy over the past six years, marked by a near halving of inflation and unemployment rates and by the successful absorption of immigrants. They expressed concern, however, about the persistence of inflation and the high current account deficit. The main policy requirement was for

Table 12

Hong Kong, China: Selected Economic Indicators

(Data as of Board discussion in February 1997)

	1993	1994	1995	1996 ¹
	<i>In percent</i>			
Domestic economy				
Change in real GDP	6.1	5.4	4.7	4.5
Unemployment rate	2.0	2.0	3.3	2.6
Change in consumer prices (period average)	8.5	8.1	8.7	6.0
	<i>In billions of U.S. dollars²</i>			
External economy				
Exports, f.o.b.	163.1	182.5	209.2	222.5
Imports, c.i.f.	155.0	181.0	214.8	221.0
Current account balance ³	8.2	1.5	-4.9	1.6
Gross official reserves	43.0	49.3	55.4	63.8
Current account balance (in percent of GDP) ³	7.0	1.6	-2.3	1.0
Change in real effective exchange rate (in percent)	10.5	1.5	-1.2	4.1
	<i>In percent of GDP²</i>			
Financial variables				
General government balance ⁴	2.5	2.3	1.3	-0.3
Gross national saving ⁵	35.8	33.8	31.0	33.0
Gross domestic investment	27.6	31.9	34.5	32.0
Change in broad money (in percent)	15.6	13.6	13.6	13.1
Best lending rate (in percent)	6.5	8.5	8.8	8.5

¹Fund staff estimates.

²Unless otherwise noted.

³Balance on goods and nonfactor services.

⁴Data are for fiscal years ending March.

⁵Foreign component of saving included for 1993 and 1994 only.

Table 13

Israel: Selected Economic Indicators*(Data as of Board discussion in December 1996)¹*

	1993	1994	1995	1996	
				Projections at time of Board discussion	Outturn ²
<i>In percent</i>					
Domestic economy					
Change in real GDP	3.5	6.8	7.1	4.3	4.4
Unemployment rate	10.0	7.8	6.3	6.3	6.7
Change in consumer prices (end of period)	11.2	14.5	8.1	12.0	10.6
<i>In billions of U.S. dollars¹</i>					
External economy					
Exports, f.o.b.	14.8	16.7	19.0	19.9	20.2
Imports, c.i.f.	20.4	22.6	26.7	28.9	28.3
Current account balance	-1.1	-2.3	-3.9	-5.2	-4.9
Direct investment	—	-0.2	1.2	...	1.6
Capital account balance	2.4	1.6	3.9	...	6.1
Gross official reserves	6.4	6.8	8.2	...	11.4
Current account balance (in percent of GDP)	-1.7	-3.2	-4.5	-5.6	-5.2
Change in real effective exchange rate (in percent)	-0.6	2.4	3.5	...	3.3
<i>In percent of GDP¹</i>					
Financial variables					
General government balance	-3.5	-2.2	-3.4	...	-4.2
Gross national saving (in percent of national income)	20.2	18.7	18.1	...	...
Gross national investment (in percent of national income)	21.8	22.0	22.6	...	...
Change in broad money (in percent)	22.0	24.6	21.7	...	2.4
Interest rate at discount window (in percent)	11.3	13.4	15.5	...	16.1

¹Unless otherwise noted.²Updated Fund staff estimates.

the authorities to strengthen domestic saving with a more ambitious fiscal consolidation effort. Directors viewed the authorities' medium-term strategy of fiscal consolidation, disinflation, and structural reform as charting the appropriate direction for the needed adjustment.

Noting that fiscal policy had been at the root of the overheating experienced in 1995/96, Directors stressed that improving public sector saving was essential and called for strict adherence to the deficit target for 1997. They viewed as important recently announced plans for additional spending cuts and the establishment of a contingency reserve. They considered the authorities' emphasis on containing expenditures helpful and suggested the adoption of more realistic revenue estimates. Directors generally regarded the existing medium-term fiscal targets as insufficient to generate the domestic saving required to sustain a

high rate of investment and to achieve low single-digit inflation in five years. They therefore urged the adoption of more ambitious medium-term objectives. They also recommended improved transparency and accountability of fiscal policy, in particular by also providing deficit estimates inclusive of the accrued liabilities associated with indexation that are excluded from the present measures and by explaining the government's accounting methodology to the public.

Directors observed that monetary policy had to bear the brunt of the fight against inflation over the past two years, but they considered that a shift to a less restrictive monetary stance should await credible progress with fiscal consolidation. They generally thought that the increased emphasis on inflation targeting within the crawling exchange rate band had provided a clarity of purpose and objectives that could facilitate the pursuit of disinflation. They urged the adoption of a forward-looking inflation strategy that could usefully integrate structural aspects—policies for releasing public lands, the privatization and regulation of utilities, and enhanced competition policies.

Directors considered that Israel's record on structural policies was mixed. Although progress had been made in liberalizing trade, strengthening antitrust and competition policy, and downsizing banks' holdings in nonfinancial companies, there was need to accelerate privatization and to decrease other forms of government intervention in the economy. Directors welcomed plans to rationalize the tax and regulatory treatment of financial instruments, but they felt that much more needed to be done if Israel were to establish a resilient and efficient capital market.

Korea

The Board concluded the Article IV consultation with Korea in November 1996. Following two years of rapid expansion led by buoyant investment and exports, economic growth moderated in late 1995 and early 1996 in response to an earlier tightening of monetary conditions and less favorable short-run export prospects. Domestic demand decelerated sharply as growth of investment in equipment slowed

because of a large capacity buildup in recent years as well as the less favorable export outlook. In late 1995 and the first half of 1996, the labor market was tight, with the unemployment rate at about 2 percent. Influenced by unfavorable agricultural price developments, consumer price inflation edged up in the first half of 1996 to 5.0 percent from 4.5 percent in 1995 (Table 14).

The fiscal situation in Korea remained sound as the result of a long tradition of fiscal conservatism. Over the years, fiscal expenditure, relatively low by international standards, had been broadly in line with revenue, resulting in moderate levels of government debt and high government saving. Monetary developments in 1995–96 were broadly consistent with the government's objectives to lower underlying inflation and achieve a soft landing. Growth of the broad monetary aggregate in 1995, although rapid at the beginning of the year, slowed to 13.7 percent by the end of December, well within the target range of 12 percent to 16 percent. Other monetary aggregates showed a similar behavior.

Since 1994, the current account deficit had widened sharply, initially in tandem with the rapidly growing economy, but subsequently mainly as a result of adverse developments in the terms of trade. Nevertheless, capital inflows, growing in response to continued relaxation of controls on foreign equity investment and on access to trade financing, had comfortably financed this deficit. In 1995 the surplus on the capital account rose to \$16 billion, and net inflows of \$14 billion were recorded during the first half of 1996. Since 1994, the authorities have progressively dismantled import barriers and cut tariffs in accordance with the Uruguay Round; except for a small number of products with potentially adverse health or security effects, import licensing is now automatic. The nominal effective exchange rate had been broadly unchanged in the period since late 1994, notwithstanding large fluctuations over the same period in key currency exchange rates.

Over the past ten years, the authorities had partially implemented two public enterprise privatization pro-

grams; the program introduced in December 1993 envisaged privatization of 58 of 133 public enterprises during 1994–98. As of mid-1996, 16 enterprises had been privatized.

In their discussion, Directors welcomed Korea's continued impressive macroeconomic performance: growth had decelerated from the unsustainably rapid pace of the previous two years, inflation had remained subdued notwithstanding some modest pickup in the months prior to the consultation, and the widening of the current account deficit largely resulted from a temporary weakening in the terms of trade. They welcomed Korea's prospective membership in the OECD and the BIS and noted the challenge of ensuring that the speed of structural reforms in the financial sector and the capital account was commensurate with the needs of Korea's transformation into an industrial economy.

Table 14

Korea: Selected Economic Indicators*(Data as of Board discussion in November 1996)¹*

	1993	1994	1995	1996	
				Projections at time of Board discussion	Outturn ²
<i>In percent</i>					
Domestic economy					
Change in real GDP	5.8	8.6	9.0	7.1	7.1
Unemployment rate	2.8	2.4	2.0	2.0	2.0
Change in consumer prices (end of period)	5.8	5.6	4.7	4.9	4.5
<i>In billions of U.S. dollars¹</i>					
External economy					
Exports, f.o.b.	80.9	93.7	123.2	129.4	128.3
Imports, f.o.b.	79.1	96.8	128.0	139.8	143.5
Current account balance	0.4	-4.5	-8.9	-17.7	-23.7
Direct investment	-0.5	-1.3	-1.9	...	-1.7
Portfolio investment	10.7	6.8	8.5	...	11.3
Capital account balance	2.6	9.1	16.0	...	24.6
Gross official reserves	20.2	25.6	32.7	...	33.2
Current account balance (in percent of GDP)	0.1	-1.2	-2.0	-3.6	-4.8
External debt (in percent of GDP)	13.3	14.7	17.2	...	22.9
Debt service (in percent of exports of goods and services)	9.1	6.2	5.4	...	...
Change in real effective exchange rate (in percent)	-1.8	0.7	1.1	...	3.6
<i>In percent of GDP¹</i>					
Financial variables					
General government balance	0.3	0.5	0.4	—	...
Gross national saving	35.2	34.9	35.1	34.5	...
Gross national investment	35.1	36.1	37.1	38.0	...
Change in broad money (end of period; in percent)	17.3	17.6	13.7	...	17.8
Three-month CDs (in percent)	12.3	14.8	11.7	...	13.5

¹Unless otherwise noted.²Updated Fund staff estimates.

Board members stressed that monetary policy should focus firmly on the ultimate goal of price stability and agreed that monetary policy should be supported by more flexibility in the exchange rate, particularly if capital inflows were to accelerate following further capital account liberalization. Greater exchange rate flexibility would be facilitated by, and would itself contribute to, the deepening of the forward market for the Korean won.

Directors praised the authorities for their enviable fiscal record and suggested that fiscal policy could best contribute to strengthening medium-term macroeconomic performance by maintaining a strong budgetary position as much-needed spending on social overhead capital was undertaken. They also welcomed the recent acceleration of capital account liberalization; although some Directors agreed with the authorities' gradual approach to capital account liberalization, a number of Directors considered that rapid and complete liberalization offered many benefits at Korea's stage of economic development. Directors agreed with the authorities' intention of not rigidly linking capital account liberalization to the narrowing of interest differentials with partner countries and noted that liberalization itself would be important in reducing Korean interest rates from the current high levels.

Directors suggested that the recent speeding up of capital account liberalization intensified the need for further reforms of the domestic financial sector. Despite considerable progress in financial sector reform, bank interest rates appeared to remain sticky, and secondary markets for many financial assets were either shallow or absent. In addition, monetary policy had not yet completed the transition to indirect instruments. Directors observed that faster progress in these areas would help to strengthen the efficiency of the financial sector and increase the effectiveness of monetary policy.

The Board welcomed the broadening of structural reforms, including labor market reforms and privatization, that should contribute to productivity gains and ensure the continued competitiveness of the Korean economy.

New Zealand

The Board concluded the Article IV consultation with New Zealand in November 1996. At the time of the meeting, economic developments in New Zealand continued to be satisfactory. Real GDP growth had slowed to a sustainable 3 percent, consistent with a soft landing rather than the recession that had been a typical feature of earlier business cycles. Employment growth remained rapid, and the underlying rate of inflation was held close to 2 percent, although the upper limit of the target range was breached slightly, partly because of a sharp rise in housing prices. The tight

stance of financial policies continued: the budget surplus had risen to nearly 4 percent of GDP in 1995/96, interest rates were kept at relatively high levels in real terms, and the exchange rate had appreciated in both nominal and real effective terms by 5 percent (Table 15). Although the external account deficit had widened to 4 percent of GDP in 1995/96, market confidence remained strong.

The economic expansion was expected to continue in 1997, propelled by the tax cuts contained in the 1996/97 budget. Under the budget, the tax burden was to be reduced by more than 1 percent of GDP in 1996/97 and in 1997/98, personal income taxes were to be lowered, and allowances were to be increased. Nevertheless, a budget surplus of 3 percent of GDP was projected for 1996/97, enabling net public debt to decline further, to 28 percent of GDP.

Directors commended the authorities for their steadfast implementation over the past decade of rigorous financial policies and comprehensive structural reform in a context of transparency and accountability. They welcomed the authorities' commitment to maintain their policy orientation over the medium term. They considered the policy stance of tight monetary conditions and public expenditure control to be appropriate because that stance helped to contain inflation, ensured sustainability of the external position, and laid the foundation for resumption of more rapid growth over the medium term.

Directors believed that the monetary framework, including the inflation-targeting regime, had been instrumental in containing inflationary expectations and securing market credibility for the overall economic strategy. While a few Directors thought that a widening of the 0–2 percent target band for inflation would allow greater flexibility for monetary policy, most Directors cautioned against such a move, at least until inflation was brought back into the band, so as not to affect adversely the credibility of inflation policy.

Directors strongly endorsed the medium-term budgetary strategy, which provided for continuing surpluses and implied a steady decline in the ratio of public debt to GDP. They urged continued progress with civil service and welfare reforms in order to free up funds for higher spending on health and education, as well as accelerated privatization of the remaining public sector trading interests. A number of Directors thought it advisable to postpone the second round of tax cuts until expenditure reductions could be clearly identified.

A number of Directors thought the size of the external current account deficit posed risks, given New Zealand's vulnerability to external shocks and to changes in market sentiment. Directors believed it would be advisable for the authorities to tighten fiscal policies, if necessary, to prevent a widening of the cur-

rent account deficit. Financial stability and continued structural reforms would help to keep the traded-goods sector competitive and to maintain private capital inflows.

Directors underscored the importance of continuing with structural reforms to enhance potential growth. In particular, they proposed perseverance in efforts to raise private investment and saving in relation to GDP and to improve education and training facilities to raise labor productivity. They welcomed the authorities' commitment to promote further multilateral and regional initiatives to liberalize trade.

Subsequent to the consultation, in December 1996 a new coalition government took office. While the economic policy stance has not been fundamentally modified, two changes are of note. First, the inflation band was widened from 0–2 percent to 0–3 percent, and the Reserve Bank signaled its intention to keep inflation in the middle part of the new band. Meanwhile, inflation pressures continued to ease; underlying inflation for the March 1997 quarter was 0.2 percent, and for the 12-month period ending March 1997 it was 2 percent on average. Second, budgeted spending on health, education, and law and order was increased for the next several years by 1½ percent of GDP a year, and the announced July 1997 tax cut was delayed by one year. However, sizable budget surpluses continue to be targeted.

Spain

The Board concluded the Article IV consultation with Spain in March 1997. Recent economic developments in the country were then generally favorable. Growth in private consumption had strengthened to about 2.5 percent (quarter-on-quarter, annualized) in mid-1996 as booming stock and bond markets added to household wealth. For 1996 as a whole, GDP grew by an estimated 2.2 percent (Table 16). Consumer inflation fell to 3.2 percent (year-on-year) in December 1996, the lowest rate in three decades. With output still below potential, unemployment remained a serious economic and social problem. After peaking at over 24 percent in early 1994, the unemployment rate was

reduced by the subsequent recovery to 22 percent of the labor force in the third quarter of 1996, still well above that of any other industrial country.

Since late 1994, monetary policy had been centered squarely on the task of lowering inflation. Inflation and monetary growth both declined during 1996, allowing the Bank of Spain to reduce the reference ten-day repurchase rate to 6 percent in January 1997 from 9.25 percent in December 1995. Fiscal policy focused on qualifying Spain for entry into EMU in 1999. The convergence plan submitted to the European Council in July 1994 called for the general government deficit to fall from 7.4 percent of GDP in 1993 to 3.0 percent in 1997, primarily through expenditure reductions. During 1994–96, multiyear limits were imposed on public sector wage increases, agreements were struck with local and regional governments to limit their deficits, controls were placed on the rise in health care

Table 15

New Zealand: Selected Economic Indicators¹

(Data as of Board discussion in November 1996)²

	1993/94	1994/95	1995/96	1996/97	
				Projections at time of Board discussion	Outturn ³
<i>In percent</i>					
Domestic economy					
Change in real GDP	6.2	5.2	2.8	2.5	2.0
Unemployment rate	9.5	6.9	6.5	6.5	6.4
Change in consumer prices (period average)	1.4	2.4	3.3	2.4	2.2
<i>In billions of U.S. dollars²</i>					
External economy					
Exports, f.o.b.	10.8	12.6	13.4	14.5	15.2
Imports, c.i.f.	9.1	11.3	12.8	14.4	14.7
Current account balance	-0.6	-2.0	-2.4	-2.8	-2.8
Direct investment	0.5	1.2	4.5	4.2	4.4
Portfolio investment	1.3	0.4	1.2	1.4	1.2
Capital account balance	1.0	1.8	2.9	2.8	2.9
Gross official reserves	3.8	3.9	4.5	4.7	4.4
Current account balance (in percent of GDP)	-1.3	-3.9	-4.1	-4.5	-4.3
Change in real effective exchange rate (in percent)	6.4	5.3	5.7	...	...
<i>In percent of GDP²</i>					
Financial variables					
General government balance	0.9	3.1	3.8	3.1	2.0
Gross national saving	18.9	17.9	18.4	17.9	18.2
Gross national investment	20.2	21.8	22.6	22.4	22.5
Change in broad money (in percent)	6.6	6.7	12.0	15.0	10.0
Interest rate on 90-day bank bills (in percent)	5.4	9.4	8.9	9.9	...

¹Data are for fiscal years ending March.

²Unless otherwise noted.

³Updated Fund staff estimates.

Table 16

Spain: Selected Economic Indicators*(Data as of Board discussion in March 1997)*

	1993	1994	1995	1996
	<i>In percent</i>			
Domestic economy				
Change in real GDP	-1.2	2.1	2.8	2.2
Unemployment rate (period average)	22.7	24.2	22.9	22.2
Change in consumer prices ¹	4.9	4.3	4.3	3.2
	<i>In billions of U.S. dollars²</i>			
External economy				
Exports, f.o.b.	62.1	74.0	92.7	103.1
Imports, c.i.f.	77.0	88.8	110.4	116.9
Current account balance	-5.8	-6.8	1.2	2.9
Net investment ³	54.2	-15.8	23.4	1.0
Net other portfolio investment ⁴	-54.5	21.2	-31.0	18.7
Capital account balance	2.9	2.6	6.0	5.9
Gross official reserves (end of period)	45.3	44.5	38.2	61.8
Current account balance (in percent of GDP)	-1.1	-1.4	0.2	0.6
Change in real effective exchange rate (in percent)	-10.5	-4.8	1.4	2.3
	<i>In percent of GDP²</i>			
Financial variables				
General government balance (Maastricht basis)	-7.4	-6.2	-6.6	-4.4
Gross national saving	18.7	18.6	21.3	21.0
Gross national investment	19.9	20.0	21.1	20.6
Change in broad money (end of period; in percent)	10.1	7.0	9.2	6.3
Three-month interbank interest rate (period average; in percent)	11.7	8.0	9.4	7.5

¹End of period, year-on-year percentage change (December on previous December).²Unless otherwise noted.³Including foreign direct investment and marketable securities.⁴Including loans, deposits, and repurchase operations.

spending, and unemployment benefits were reduced. Although progress on fiscal consolidation in 1995 was disappointing, the situation improved during 1996. Preliminary data suggested that the general government deficit target of 4.4 percent of GDP on a national accounts basis was attained.

Spain's external position remained strong. The external current account moved to a surplus of 0.6 percent of GDP in 1996 from 0.2 percent in the previous year, owing to an improvement in the trade balance and tourism. Official foreign reserves rose from \$36 billion in March 1995 to \$65.3 billion at the end of January 1997, against the background of considerable net capital inflows. Over the same period, the peseta was maintained close to the middle of the ERM band.

In their discussion Directors commended the authorities for their sound macroeconomic policies and particularly for progress in fiscal consolidation and structural reforms. They observed that Spain seemed poised in 1997 for a strengthening of the economic recovery and sustainable growth over the medium

term. They also welcomed Spain's firm commitment to meeting the Maastricht convergence criteria in 1997 and considered that this achievement was within the authorities' reach. They agreed that the authorities should be prepared to introduce additional fiscal measures, if needed to ensure compliance with the Maastricht criteria.

Directors urged the authorities to take early steps to place the fiscal consolidation process on a sustainable footing. They noted that it would be necessary to go beyond the temporary expenditure cuts and to undertake a comprehensive restructuring of government expenditure. On the revenue side, some Directors encouraged the authorities to improve the tax code by a reduction in the marginal tax rates.

Directors complimented the Bank of Spain for its success in reducing inflation, noting that the increased independence of the bank and its inflation-targeting framework had worked well. They agreed with the authorities that the recent low inflation data might allow prudent interest rate cuts, although subsequent reductions in interest rates should be linked to clear progress on the fiscal front.

Because of the strong performance of the external sector in recent years, Directors generally agreed that competitiveness was not an immediate problem. Nevertheless, they stressed the need for structural reforms and continued wage moderation to ensure the maintenance of external competitiveness over the medium term. As regards internal competition, they encouraged the authorities to move ahead in improving the markets for urban real estate, professional services, and retail trade and in implementing a more market-oriented autonomous regulatory framework for monopolies.

Directors observed that the high unemployment rate and severe labor market rigidities remained the most pressing policy challenge. Spain's prospective entry into the EMU made it imperative for the authorities to undertake labor market reforms without delay.

Sweden

The Board concluded the Article IV consultation with Sweden in September 1996. During 1990-93 Sweden

had experienced its worst postwar economic crisis, but, propelled by strong export performance, the economy had been making a strong recovery since the second quarter of 1993. Real GDP growth reached 3.6 percent in 1995, the highest rate since 1987 (Table 17). Consumer price inflation dropped to below 2 percent beginning in January 1996, partly as a result of the appreciation of the krona and declining mortgage interest rates. Wage increases, however, continued to be uncomfortably high; although total unemployment edged down slightly, it remained above 12 percent in the first quarter of 1996.

After the general government deficit reached 12.3 percent of GDP in 1993, Sweden had set its public finances firmly on a path of fiscal consolidation. The EMU Convergence Program adopted by the government in June 1995 specified measures expected to reduce the deficit by 7.5 percent of GDP by 1998—with the reduction split evenly between spending decreases and tax increases. With rapid output growth, it was expected that the fiscal deficit would narrow to 2.5 percent of GDP in 1997 (meeting the Maastricht criterion), but weakened economic activity since late 1995 had altered this outlook. In April 1996 a Supplementary Budget Bill accordingly proposed additional expenditure measures of SKr 12 billion to bring the deficit below 3 percent of GDP in 1997. The positive reception of this bill in the markets also eased pressure on the krona and on interest rates. By mid-July 1996 the krona had appreciated by 18 percent from its low point in 1995, and the differential in long-term interest rates with Germany had narrowed to 160–170 basis points, or about one-third of its highest level in early 1995.

In their discussion, Directors noted that the Swedish economy was well on its way to recovery from the crisis of 1990–93. The Swedish inflation rate was among the lowest in Europe. Directors commended the authorities for their steadfast pursuit of a strong program of fiscal consolidation and the successful resolution of the banking crisis. These successes had enhanced government credibility in financial markets. Directors emphasized, however, the need for structural reforms in the labor market to help moderate wage

inflation and reduce the high unemployment rate, as well as full implementation of the fiscal consolidation program. Noting the sensitivity of fiscal consolidation to growth, Directors welcomed the adoption of additional fiscal measures in the April 1996 Supplementary Budget Bill to keep the fiscal consolidation program on track, as well as the greater weight put on expenditure reduction in these measures.

With evidence of the growing credibility of policies, and in view of the high level of unemployment, Directors concurred that easing monetary policy had been an appropriate initiative. Most Directors considered that the Riksbank's monetary policy framework, including inflation targeting, had contributed to reducing inflation. Some Directors thought a strong commitment to EMU membership would help to safeguard the favorable market sentiment that had been gained.

Directors welcomed the appreciation of the krona during the preceding year and generally concurred

Table 17
Sweden: Selected Economic Indicators
(Data as of Board discussion in September 1996)¹

	1993	1994	1995	1996	
				Projections at time of Board discussion	Outturn ²
<i>In percent</i>					
Domestic economy					
Change in real GDP	-2.2	3.3	3.6	1.1	1.1
Unemployment rate	8.2	8.0	7.7	8.0	8.0
Change in consumer prices (period average)	4.6	2.2	2.5	0.5	0.5
<i>In billions of U.S. dollars¹</i>					
External economy					
Exports, f.o.b.	49.4	60.0	79.7	...	84.5
Imports, c.i.f.	42.5	51.3	64.9	...	66.6
Current account balance	-4.0	0.8	4.9	6.2	6.1
Direct investment	2.4	-0.4	3.1	...	0.6
Portfolio investment	4.1	4.8	-5.2	...	-3.5
Capital account balance	3.8	-0.8	-5.0	...	-6.0
Gross official reserves	2.5	3.1	3.4	2.9	2.9
Current account balance (in percent of GDP)	-2.2	0.4	2.1	2.5	2.4
Change in real effective exchange rate (in percent)	-23.7	-2.2	-1.2	11.6	9.9
<i>In percent of GDP¹</i>					
Financial variables					
General government balance	-12.3	-10.8	-8.0	-4.0	-2.5
Gross national saving	11.3	14.5	17.5	17.7	17.2
Gross national investment	13.3	14.1	15.5	15.1	14.7
Change in broad money (M3; in percent)	4.0	0.3	2.7	11.7	11.7
Three-month interbank interest rate (period average; in percent)	8.5	7.6	8.8	6.0	6.0

¹Unless otherwise noted.

²Updated Fund staff estimates.

Table 18

Algeria: Selected Economic Indicators*(Data as of Board discussion in June 1996)¹*

	1992	1993	1994	1995	1996 ²
	<i>In percent</i>				
Domestic economy					
Change in real GDP	1.6	-2.2	-1.1	4.3	4.0
Unemployment rate	21.3	23.2	24.4	24.8	28.0
Change in consumer prices (end of period)	28.0	16.1	38.6	21.9	15.1
	<i>In billions of U.S. dollars¹</i>				
External economy					
Exports, f.o.b.	11.5	10.4	8.9	10.3	12.6
Imports, f.o.b.	8.3	8.0	9.2	10.2	9.6
Current account balance	1.3	0.8	-1.8	-2.3	0.2
Direct investment	0.0	0.0	0.0	0.0	0.2
Capital account balance	-1.2	-0.8	-2.5	-3.9	-2.8
Gross official reserves (end of period)	1.5	1.5	2.6	2.1	3.7
Current account balance (in percent of GDP)	2.8	1.6	-4.3	-5.6	0.3
External debt (in percent of GDP)	52.0	53.0	70.3	78.4	72.4
Debt service (in percent of exports of goods and services)	78.3	82.2	48.7	43.8	32.7
Change in real effective exchange rate (in percent)	27.0	14.2	-28.7	-6.0	5.0
	<i>In percent of GDP¹</i>				
Financial variables					
Central government balance	-1.2	-8.7	-4.4	-1.4	2.6
Gross national saving	31.2	30.8	27.4	26.5	28.3
Gross national investment	28.4	29.2	31.8	32.0	28.0
Change in broad money (in percent)	23.9	21.5	15.4	10.5	15.0
Repurchase rate (in percent)	17.0	17.0	21.0	23.0	20.0

¹Unless otherwise noted.²Fund staff estimates.

with the authorities' view that the krona appeared to be at or close to equilibrium. They were concerned, however, with the high rates of wage increases, which could increase inflation, decrease competitiveness and the momentum of growth, and slow the reduction of unemployment.

Directors welcomed the initiatives of the Employment Bill, although a number of Directors considered them insufficient to meet the authorities' employment objectives. They urged reforms to increase the flexibility of the labor market and supported the formulation of a new wage-setting mechanism. Several Directors stressed the importance of greater wage differentiation and of measures to facilitate the employment of new entrants into the labor market.

Developing Countries

Algeria

The Board concluded the Article IV consultation with Algeria in June 1996 and conducted the second review

under the extended arrangement for Algeria. In 1995, real GDP was estimated to have increased by 4.3 percent—after two years of decline—driven by a strong export-led expansion in the hydrocarbon sector, a rebound of agriculture, and an upturn in the construction and services sectors (Table 18). Inflation fell from 39 percent in the 12 months to the end of 1994, to 22 percent by the end of 1995. Unemployment remained high.

The fiscal deficit narrowed to 1.4 percent of GDP in 1995 from 4.4 percent in 1994. The ratio of revenue to GDP increased, mainly owing to higher hydrocarbon receipts. On the expenditure side, interest payments exceeded targets, but the fiscal program was kept on track as the authorities cut current outlays and contained salary increases. As a result, civil service wages fell substantially in real terms.

Fiscal adjustment provided the underpinning for a tight monetary policy, as demand for broad money continued to grow less than nominal GDP. Credit to the economy rose by 85 percent in 1995; an expansion in credit to food-importing agencies and the railway company was partly offset by a sharp contraction of credit to the government and by

increased bank provisioning and recapitalization. Real interest rates became positive in late 1995.

Notwithstanding demand restraint and a substantial real depreciation of the Algerian dinar in 1994, the external current account deficit increased by 1.3 percentage points to 5.6 percent of GDP in 1995. Imports rose in response to trade liberalization and higher cereal prices. However, the balance of payments strengthened significantly in the first half of 1996, as the trade balance responded strongly to the dinar depreciation, more than offsetting a drying up of short-term inflows in the form of suppliers' credit pending an expected debt-rescheduling agreement, and official reserves rose.

In financial sector reform, the introduction of regular repurchase auctions on the money market in May 1995 was later followed by the institution of a formal auction system to sell negotiable treasury bonds on the money market, with a view to establishing open market operations by the central bank. In the public enterprise sector, enterprises were put under hard budget con-