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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/26

10:00 a.m., February 17, 1984

J. de Larosière, Chairman
W. B. Dale, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	L. K. Doe, Temporary
J. de Groote	
	X. Blandin
	C. A. Salinas, Temporary
	M. K. Bush
M. Finaish	
	Y. Okubo, Temporary
J. E. Ismael	Jaafar A.
	L. Leonard
	C. Robalino
	G. Grosche
G. Lovato	C. P. Caranicas
	A. S. Jayawardena
	E. M. Ainley, Temporary
J. J. Polak	
	K. G. Morrell
	H. Alaoui-Abdallaoui, Temporary
	M. Camara, Temporary
	J. L. Feito
J. Tvedt	A. Lindø
	T. A. Clark
	Wang E.

J. W. Lang, Jr., Acting Secretary
J. A. Kay, Assistant

Also Present

African Department: M. E. Massourakis. Asian Department: W. G. L. Evers, L. Mendras, H. O. Roden, G. Szapary. European Department: L. A. Whittome, Counsellor and Director; F. C. Adams, D. A. Brodsky, T. Catsambas, B. Christensen, P. B. de Fontenay, A. Fidjestol, M. T. Hadjimichael, W. E. Hermann, P. J. F. Nyberg, D. M. Ripley, H. Vittas, M. Xafa. Exchange and Trade Relations Department: D. K. Palmer, Associate Director; S. Mookerjee, Deputy Director; E. J. Zervoudakis. Legal Department: G. P. Nicoletopoulos, Director; W. E. Holder, J. V. Surr. Research Department: L. Alexander. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: S. R. Abiad, H. A. Arias, H.-S. Lee, W. Moerke, G. E. L. Nguyen, D. C. Templeman. Assistants to Executive Directors: M. Eran, G. Ercel, I. Fridriksson, V. Govindarajan, H. Kobayashi, A. Koné, G. W. K. Pickering, M. Rasyid, J. Reddy, D. J. Robinson, A. A. Scholten, Shao Z., S. Sornyanyontr, N. Toé, J. C. Williams.

1. GREECE - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with Greece, together with a proposed decision concluding the 1983 Article XIV consultation (SM/84/21, 1/18/84; and Sup. 1, 2/10/84). They also had before them a report on recent economic developments in Greece (SM/84/37, 2/3/84).

Mr. Caranicas made the following statement:

The Greek authorities would like to express their appreciation for the staff's excellent analysis of financial and economic developments in Greece and also for the constructive approach to the discussions recently held in Athens. The authorities certainly gained a great deal from the full and frank exchange of views with the staff mission. These discussions focused on the important policy issues, as well as on policy options in the present environment of great economic uncertainties and slowly improving world economic conditions.

As pointed out in the staff report, the Government that assumed office at the end of 1981 had in many respects a formidable task. Little progress had been made in adjusting to the oil shocks of the 1970s or in correcting the long-standing distortions characterizing the economy. Overall growth in real terms had been following a declining trend from its peak in 1978, and in 1981--for only the second time in 30 years--turned negative. Private fixed investment declined by more than 11 percent for the second year in succession. The current account deficit on the balance of payments reached an all-time high of nearly 6.5 percent of GNP. Moreover, the financial policies that had been pursued by the preceding government had led to a doubling of the public sector's net borrowing requirement from 7 percent to 14 percent of GNP. Prior to the elections, financial policies were considerably eased, and inflation in 1981 remained for the second consecutive year at about 25 percent.

The new Government was fully aware of the somewhat limited room for maneuver in implementing its policies, at least in the short run. It had made certain social and political commitments to the electorate, particularly as regards raising the earnings of lower-income workers. At the same time, economic realities required that immediate attention be given to stabilizing the economy and improving competitiveness. During 1982 and 1983 imbalances--both internal and external--have been moderated, although developments have been less satisfactory than the authorities had expected. There are firm indications that recovery has begun. The authorities now estimate that, after two years of decline, real growth of GNP in 1983, thanks to a recovery of industrial production, was 0.3-0.4 percent. Growth would have been larger had there not been a fall in agricultural output of between 4 percent and 5 percent in real terms.

The overall policy stance gives priority to the stabilization of the economy in an attempt to bring it gradually back to a noninflationary growth path. Given the unfavorable initial conditions surrounding the policy of the new Government, the results have been modestly successful. For 1984, the authorities have maintained an essentially unchanged policy stance, and their targets are realistic within the context of gradual stabilization and noninflationary recovery. According to official projections, deficits in the balance of payments and in the public sector will be held in check, while unemployment will trend downward. It is to be noted that on account of the increase in the inflow of private capital, the net external borrowing requirement was reduced in 1983. That increase is expected to continue during 1984, producing--together with anticipated increases in public and private investment and in exports--a rate of growth of at least 1.5 percent in GNP this year. These results, together with the expected deceleration of inflation to 18 percent and the effects of broad government policies to improve productivity, would signal not merely an economic recovery but the effects of a fundamental restructuring of the economy.

Progress has been made in reducing inflation from its peak of 25 percent in 1981 to about 20 percent in 1983. A greater deceleration had been impeded mainly by the oligopolistic structure of important segments of the private sector and by the depreciation of the drachma, which has supported high inflationary expectations and speculative tendencies. Except for unforeseen external disturbances, inflation is expected to decelerate by at least 2 percentage points in 1984, mainly because of the substantial slowdown of the cost of labor per unit of output in 1983, as well as the nonaccommodating monetary policy pursued by the authorities. Given that Greece already has a history of high inflation, the authorities are convinced that, apart from the effects of stabilization policy, the problem of inflation will be resolved in the medium term with the recovery in productivity and the easing of the substantial structural factors that generate built-in inflationary pressures.

In the policy sphere, perhaps the most notable development has been the marked tightening of monetary policy since the middle of 1982. This tightening has been achieved through selective increases in interest rates and tighter credit controls to reduce the leakages that had inflated the monetary and credit aggregates in earlier years. Commercial banks' overdraft possibilities with the Bank of Greece have also been considerably reduced. The tightening of monetary policy has been reflected in a substantial deceleration of the monetary and credit aggregates. Thus, the rate of domestic credit expansion has been reduced from 35.5 percent in 1981 to 20 percent in 1983.

Fiscal imbalances have also been reduced since 1981, although progress has not been as rapid as the authorites had hoped. Central government expenditure targets were broadly met in both 1982 and 1983. The relatively large overrun in the deficit in 1983 can be attributed to a slower than anticipated growth in tax revenues, resulting in part from the two-month strike of tax collections in the spring of 1983 (as well as the slower than anticipated growth in real output).

Reflecting the Government's commitment to augment earnings of lower-paid workers, average real wages had increased considerably in 1982. But in 1983, cost of living adjustments were delayed for several months and as a result real wages fell by about 3 percent. The increase in unit labor costs in manufacturing, which had reached nearly 38 percent in 1982, was reduced by more than one half. In combination with the nominal depreciation of the drachma over the course of the year, this led to a substantial increase in the competitive position of Greek exports. Preliminary data for 1983 indicate an enhanced competitiveness that is being translated, with a lag, into higher export volumes. The authorities expect that the more competitive exchange rate, along with continued economic recovery, will also contribute to a recovery of invisibles' earnings--notably tourism, shipping, and emigrants' remittances--and hence that imports can be allowed to increase somewhat this year without jeopardizing the balance of payments.

Shortly after the presentation of the budget to Parliament, the incomes policy for 1984 was delineated by the Government. It was designed to support the recovery started in the second half of 1983 and expected to develop further this year. A more relaxed standard will be applied to incomes, which will be allowed to increase by up to 24 percent for the lower-paid workers, an increase in excess of the anticipated rate of inflation. However, the degree of indexation will fall away sharply for those with wages above the threshold to which full indexation is applied--for this year the threshold was raised to $500 a month. All indexation adjustments will be made promptly every four months.

For 1984, the prospects are for further economic recovery and a continued gradual reduction in the internal and external imbalances. The authorities expect the decline in private fixed investment to be reversed, as a result of both economic recovery and the enactment of investment incentives laws which have made clear "the rules of the game." Real economic growth of 1.5 percent is projected, based on increased exports of goods and services--largely reflecting the enhanced competitiveness of the economy and increased gross investment. Fiscal policy is projected to be less expansionary in 1984 than in 1983, with smaller volume increases in both public consumption and public investment.

The net public sector borrowing requirement, as a percent of GNP, is estimated to be slightly lower in 1984 compared with 1983. Monetary policy will continue to be nonaccommodating. While slightly reducing the overall rate of credit expansion for 1984, the recently announced monetary program provides sufficient credit to the private sector and reduces the rate of credit expansion to the public sector. Finally, for 1984 we have higher deposit interest rates, as well as a substantial increase (by 2.75 percentage points) in the interest rates on treasury bills. These measures were taken in an attempt to stabilize the savings ratio; they also constitute important steps toward the required rationalization of the entre credit system in Greece.

With regard to the current account deficit in 1984, the authorities' projections show that it will be held, in terms of U.S. dollars, at approximately the current level, as the anticipated rise in imports will be offset by increased exports of goods and services. Autonomous capital inflows, which do not add to the existing debt, are expected to increase considerably, as a result of both economic recovery in the OECD countries and appropriate domestic policy measures--such as the recently announced increases in interest rates on savings accounts. The amount of foreign borrowing required to finance the current account deficit is therefore expected to drop considerably, thereby slowing the rise in external indebtedness.

While the prospects for 1984 are generally favorable, the authorities are aware that overcoming the major structural problems identified in the staff report requires appropriate domestic policies. With a good measure of political courage and commitment, the first steps have already been taken. The authorities realize that consolidation of these steps and a sufficient pace of adjustment are critical, especially if the pace of foreign borrowing is to be slowed down. For the longer term, the authorities remain committed to the objectives of reducing disparities in incomes, eliminating oligopolistic distortions, and modernizing and restructuring the economy with the help of a major public investment program.

These objectives have been incorporated into the Government's five-year plan, the broad outlines of which were presented to Parliament in 1983. The plan emphasizes inter alia the role of structural change in improving cost competitiveness, strengthening production in the export and import-competing sectors, and providing a more even pattern of regional development.

Ms. Bush said that she recognized that the Greek authorities had had to contend with a number of difficult structural problems in a rather unfavorable world economic environment. Some progress had been made in adjusting to the oil shocks and in arresting the decline in several sectors of the economy. Nevertheless, some important ultimate objectives of economic policy, such as the achievement of adequate rates of real growth, price stability, and a sustainable external position, were still not assured.

It seemed clear, Ms. Bush went on, that continued adjustment efforts were needed. Yet, the authorities' policy objectives in a number of areas, such as the current account deficit, the debt service burden, inflation, and the public sector deficit, did not seem very ambitious. The authorities had set certain socioeconomic objectives: to improve economic conditions for the lower-income groups; to support small businesses and agriculture; to better allocate resources; and to raise investment in high technology and research and development ventures. It was not clear that the policies proposed with regard to interest rates and credit, relative wages and prices, or investment would be adequate to achieve those objectives. In particular, if the composition of economic growth was to be shifted toward exports and productive investment, specific incentives would have to be created and an appropriate economic framework would have to be put in place.

Prospects for growth in Greece would be strongly influenced by the rate of capital formation, Ms. Bush considered. Yet there had been a decline of 4 points between 1979 and 1983 in the ratio of gross fixed investment to GNP. In addition, the ratio of public investment to GNP had increased from 4.9 percent to 5.6 percent, while the private investment ratio had fallen from 16.4 percent to 11.7 percent. Those changes suggested the need for an increase in the overall investment ratio, an awareness of the importance of confidence, and a reassessment of existing incentives for private investment. The effect on business profitability of continued rapid increases in wage rates, brought on largely by wage indexation coupled with the continued use of price controls, was certainly a disincentive. It would moreover be interesting to know whether the growth of public sector investment had been complementary to, or competitive with, private investment. Would the growth in public sector investment contribute to, or detract from, the authorities' goal of stimulating small business?

Rather modest progress had been made in bringing down the increase in the consumer price index from its 1981 peak of 24.5 percent to 20.5 percent in 1983, Ms. Bush considered. Cost-push factors seemed likely to be in evidence in 1984, especially as there had been no significant change in the wage indexation system. At the same time, the continued large public sector deficit would place pressure on the monetary authorities to accommodate such cost pressures, thereby endangering the monetary restraint that had begun to be put in place.

The deficit on the current account of the balance of payments had been reduced from $2.4 billion in 1981 to somewhat less than $2 billion in 1983, Ms. Bush noted. However, neither the circumstances of the improvement nor the present level of the deficit were at all reassuring. Between 1979 and 1983 exports in nominal terms had been virtually unchanged, and import compression had led to a reduction in total imports. The decline in receipts from invisibles from $6.5 billion in 1981 to $5.3 billion in 1983 might--as the Greek authorities suggested--reflect to some extent the weakness of world demand. Nevertheless, she did not find that argument wholly convincing. For instance, Table 49 in SM/84/37 suggested that Greece had been relatively less competitive for the tourist trade compared with Italy, Spain, or Portugal in 1983 than it had been in 1980. Moreover, even if the current account deficit were to be held down to about $2 billion in 1984, it would still represent a ratio to GNP of over 5 percent. The persistence of such a large deficit raised problems not only for future financing but also for the rising debt service burden that it implied.

Incomes policy and fiscal policy were the key instruments for achieving Greece's ultimate economic objectives, Ms. Bush remarked. The slowdown in wage indexation adjustments in 1983 had clearly been helpful in limiting the rise in unit labor costs from the exceptionally high rate of nearly 38 percent in 1982 to somewhat less than 16 percent-still very high by standards elsewhere--in 1983. Having made such a good start, it would be regrettable if the Greek authorities did not continue to try to keep wages under control in 1984 by modifying the indexation mechanism in some way. She noted from Mr. Caranicas's remarks that a more relaxed standard of wage indexation would be applied in 1984; she hoped that the change would contribute further to the authorities' efforts to hold down increases in unit labor costs. If the public were aware of the distinction between nominal wage increases and real wage increases, more wage restraint might be achieved. For instance, even in 1982, when average nominal earnings for all sectors of the economy had risen by 27 percent, real average earnings had risen by only slightly more than 5 percent. Similarly, in each of the three years before 1982, and in 1983, real average earnings had actually fallen, despite increases in nominal earnings. That outcome seemed to her once again to be evidence of the cost-push effect of relatively high wages on prices.

Many countries suffered from public sector deficits, Ms. Bush commented, but in Greece the net borrowing requirement had ranged between 12 percent and 14 percent of GNP in each of the past three years. The target of 12.6 percent for 1984 would represent only a very modest decline from 1983. She encouraged the authorities in their efforts to improve tax collection, even though it would be unwise to place much hope on large increases in revenues from that source in the short term. Although the effects of the tax collectors' strike in 1983 should be reversible, the authorities should concentrate on the control of expenditures as a priority. A rise of 10 points in the ratio of central government expenditures to GNP between 1980 and 1983 was worrying, especially when unaccompanied by any equivalent rise in revenue. The authorities would need to restrain expenditure both in current operations and in investment.

While it was encouraging that some steps had been taken to simplify the schedule of interest rates on the lending side and to eliminate the prior import deposit system, Ms. Bush remarked, most interest rates--whether on lending or deposits--were hardly positive, if at all. In addition, the apparatus of direct controls over bank credit and over fixed portfolio investment severely restricted the ability of market forces to influence the efficient allocation of credit. Negative real interest rates of about 6 percent on savings deposits did little to encourage household savings, with unfavorable consequences for small business growth, the expansion of investment, or international capital flows. She noted from SM/84/21, Supplement 1 that rates on savings and time deposits as well as on treasury bills had been increased on February 15; she encouraged the authorities to realign the interest rate structure and to contain monetary growth.

She understood that it was not easy clearly to identify the need for exchange rate adjustments or to pass judgment on the appropriate size of any adjustment that might be made, Ms. Bush stated. Nevertheless, the staff figures seemed to show that there had been a real effective appreciation of the drachma of more than 17 percent between 1980 and 1983, although there would be no apparent appreciation if relative consumer price movements were compared instead of relative unit labor costs. One explanation of the difference would be that profit margins had been squeezed, a conclusion supported by the continued use of price controls. In any event, some depreciation of the drachma might be inevitable, although a more rapid reduction in the rate of domestic inflation would be a better way of dealing with the problem.

In brief, although some progress had been made in addressing the country's structural problems, Ms. Bush concluded, the proposed very gradual approach to correcting them was not having the desired effect. She encouraged the Greek authorities to examine with care their present strategy, and to see whether they could not accelerate their policy actions in a number of fields.

Mr. Grosche recalled that when the Executive Board had previously discussed the economy of Greece (EBM/83/53, 3/23/83) his chair had stated that the economic policies adopted by the authorities in the previous year had seemed to be appropriate, and that encouraging progress had been made in important areas. The same did not hold true for developments in 1983. The imbalances were substantial and the size of the adjustment required was still very large. The staff had appropriately described both the problems and their causes; he therefore supported the staff analysis and would only comment on the policy measures that were needed to correct economic imbalances.

Speaking more generally, Mr. Grosche observed that one of the most controversial questions about economic policy in Greece was whether the speed of adjustment envisaged by the authorities was appropriate. In 1983 his chair had expressed the view that the pace of adjustment envisaged for the coming year seemed rather gradual. Developments in the past year seemed to have borne out that view. The staff had said, first, that the gradual adjustment of the current account deficit envisaged by the authorities, which was at best only to start in 1985, would not be sufficient to prevent a further sizable increase in the debt service ratio over the next few years, and, second, that a sizable loss of competitiveness had occurred since the 1983 devaluation. What was needed was a substantial reduction in the relative share of public and private consumption in favor of productive investment and exports. Otherwise, it was difficult to see how the Greek economy would return to overall equilibrium, or how the increase in the external debt burden would be contained within manageable limits. The Wall Street Journal of February 14, 1984 had reported that the Greek authorities would be expected to pay higher spreads in arranging a new international bank loan, while other debtor countries were managing to arrange improved loan terms. If true, the article was another sign that speedy action was needed. While the recovery under way in Europe would help to alleviate the external constraints, it would not remove the need for major corrective measures. A small open economy like that of Greece could not for any length of time pursue substantially different economic policies from those followed by its main trading partners.

He did of course understand that there were a number of impediments to the authorities' progress, Mr. Grosche commented. Apart from facing political constraints and marked structural weaknesses, they were compelled to strike a delicate balance between their political and social objectives on the one hand and an urgently needed adjustment on the other. Nevertheless, he hoped that the authorities would be able to accelerate their actions substantially.

As to fiscal policy, Mr. Grosche noted that there was broad understanding within the country that Greece could not solve its problems without budgetary restraint. But the reduction in the public sector deficit envisaged by the authorities for 1984 was modest. There was even the risk that the reduction might not take place unless the authorities introduced additional measures. The staff had made specific suggestions for the areas in which action was called for; he fully supported the staff, in particular in calling for the avoidance of further delays in implementing the value added-tax. In addition, there might surely be scope for increasing taxes on income from self-employment, including agriculture. Even with those changes, he fully shared the staff view that the brunt of any effort to reduce the deficit would need to focus on expenditure control.

Incomes policy would clearly have to play a crucial role in reducing inflation in Greece, Mr. Grosche observed. The changes in the indexation system introduced in 1983 should be considered as no more than a first step. He agreed with the staff in its indications of where further modifications would be appropriate. He was worried that the proposed real increase in wages of civil servants would not help to reduce inflation; indeed, it might have adverse effects on private sector wage settlements. Some reduction in real wages might be a part of the unavoidable sacrifices during the adjustment process, and it might be better if incomes from self-employment were also to bear the cost of adjustment.

He noted that monetary policy had been tightened substantially in 1982 and again in 1983, Mr. Grosche remarked. Such a policy stance had been appropriate and even commendable; and a further tightening of monetary policy in 1984 would also be correct. However, as he understood the information provided in SM/84/21, Supplement 1, the authorities intended to adopt a monetary policy that might be no more than nonaccommodating. At least, domestic credit to the private sector was expected to increase faster than net credit to the public sector. That was a distinct improvement, because in the past, due to the large borrowing requirement of the public sector, the burden of monetary restraint had fallen excessively on the private sector. A further deceleration in the growth of liquidity should be accompanied by an appropriate reduction in the public sector borrowing requirement. He fully supported the views expressed by the staff on interest rate policy and credit allocation.

Speaking on competitiveness and exchange rate policy, Mr. Grosche remarked that in a small open economy the risk of accentuating the worst effects of devaluation and inflation by the adoption of an indexation mechanism ought to be borne in mind. He therefore agreed with both the authorities and the staff that competitiveness should be improved preferably by reducing domestic inflation. If progress could be achieved in reducing inflation, only moderate adjustments of the exchange rate would be needed. The question of competitiveness was however not only one of cost and price differentials. In Greece it was also related to the quality and design of Greek export products, as well as to a decline in productivity and the fall in industrial investment. He was wondering, however, whether more foreign direct investment could contribute to improving the prospects for exports and the balance of payments. The adoption of stronger price controls, apparently envisaged by the authorities, could help to dampen some of the price pressures, but they would certainly not help to increase investment and productivity. Internal consumption would have to be reduced to free resources for investment and export.

Mr. Ainley said that he was in general agreement with the staff appraisal and that he could support the proposed decision. Despite the authorities' efforts, the economic position in Greece had not improved very much since Executive Directors' consideration of the previous Article IV consultation (EBM/83/53). The Greek economy continued to face slow growth, rising unemployment, and high inflation. The fiscal and external accounts were in sizable deficit, and the ratio of debt service payments to foreign exchange earnings had risen sharply. Although a modest recovery was in prospect for 1984, the medium-term outlook was not encouraging, due mainly to long-standing structural weaknesses.

Against that background, Mr. Ainley went on, he agreed with the staff on the need for a coordinated set of policies aimed at reducing inflation, strengthening the public finances, and improving competitiveness. If such policies were implemented in the short run, the authorities would have a sound basis on which to modernize and restructure the economy over the medium term.

The staff clearly considered that the authorities were not moving quickly enough to adjust the economy, Mr. Ainley remarked. Incomes policy, for example, was an important element in the fight against inflation, and the commendable tightening of incomes policy in 1982 had helped significantly to reduce the growth in unit labor costs. Those gains could however be jeopardized by the recent large wage increases for civil servants and by the decision to raise the threshold for salaries that qualified for full indexation. Given the importance of restoring competitiveness in the manufacturing sector, he hoped that the authorities would consider modifying the indexation system along the lines suggested by the staff. He recognized the political constraints, but other European countries had made similar modifications in like circumstances.

He also noted that the authorities intended to rely more heavily on price controls in the future, Mr. Ainley stated. There was however a risk that such controls would lead to distortions and inefficiencies. They could also compress profit margins further and reduce the incentives for new private investment, which the authorities were seeking to encourage.

As to fiscal policy, it was evident that progress had not been as rapid as the authorities hoped, Mr. Ainley observed. The public sector borrowing requirement remained at a very high level in relation to gross domestic product. He therefore commended the recent moves to strengthen expenditure controls and to improve the tax administration. Nevertheless, he shared the staff's view that more would have to be done, particularly on the expenditure side, if the fiscal position was not to deteriorate further in 1984. He hoped that the value-added tax would be introduced in January 1986, as planned; it would provide a much needed expansion of the tax base.

There was also scope to strengthen the financial position of the public enterprises, which were now incurring sizable operating losses, Mr. Ainley considered. The increases in administrative prices mentioned in SM/84/21, Supplement 1 were a useful first step. Similarly, there was a need to review the financing of the social insurance funds, whose long-term future--according to SM/84/37--was uncertain.

The tightening of the monetary stance since mid-1982 had resulted in a substantial deceleration of the monetary aggregates, Mr. Ainley noted, but continued restraint was needed if inflation was to be brought under control. He welcomed the measures taken to strengthen the instruments of monetary policy, and the treasury bill market in particular. He supported the continuing moves to simplify the complex system of credit regulation which, as the authorities recognized, was not meeting the objective for which it was designed.

With regard to the external sector, Mr. Ainley agreed with the staff that the current account deficit could not be sustained indefinitely at its present level, without adding considerably to the already high debt burden. Part of the deficit could be traced to structural and cyclical factors. But the sharp fall in the volume of non-oil exports, and the loss of market shares, had been associated with long periods of weakening competitiveness. A flexible exchange rate policy of the kind followed since August 1983 should help to improve competitiveness, provided that it was supported by firm financial policies. He hoped that the authorities would also press ahead with other measures to diversify the export base and encourage capital inflows. He welcomed the elimination of the advance import deposit scheme, and he encouraged the authorities to remove the remaining import restrictions as soon as possible.

Finally, Mr. Ainley stated, he could endorse the principal economic objectives of the five-year plan, outlined by Mr. Caranicas. The emphasis on improving productivity and nonprice competitiveness was particularly appropriate if Greece was to benefit fully from membership in the European Community. Nevertheless, a determined adjustment effort, which could provide confidence both at home and abroad, seemed essential if the authorities were to achieve their medium-term objectives.

Mr. de Groote remarked that the efforts of the Greek authorities to reduce the fundamental imbalances in their economy had only resulted in a very modest improvement during 1983. The staff had rightly mentioned that the domestic political constraints and the severity of the structural problems facing them had forced the authorities to opt for a gradual approach. However, more emphasis should be placed on the central question of which measures were most appropriate for speeding up the adjustment effort and reducing the public sector and current account deficits. Finding an answer to those questions was all the more urgent since by 1985 Greece would no longer enjoy the transitional arrangements regarding entry into the European Community. A substantial improvement in the balance of payments, together with a reduction of the public sector deficit, seemed vital for Greece's entry into the Community. In that connection, he was particularly disturbed by the considerable loss of competitiveness, which had been well documented by the staff. During the 1982 consultation, the staff had pointed out that, at least in the initial phase, Greece's imports were expected to increase more than its exports as a result of membership in the European Community. The best way to reverse the deterioration in the balance of trade would therefore be to improve competitiveness by the adoption of a more active exchange rate policy. Another way of increasing competitiveness would be to reduce the basic inflation differential between Greece and its main trading partners.

The authorities' policy of fighting the inflation differential with a system of price controls did not seem to offer a viable solution, Mr. de Groote stated. While he agreed with the staff that such a policy could help to offset some of the price pressures, it could easily result in distortions and allocative inefficiencies. He did not find much evidence of the existence of enterprises enjoying supposedly excessive profit margins. He would appreciate further comments from the staff regarding the magnitude of the profit margins and their supposed impact on the economy. There was at least a case for the alternative view that an exchange rate policy conducive to increased competitiveness and a domestic policy of freely market-determined prices would maintain profit margins at a level compatible with the need for incentives in the investment sector. Was the strategy of intervening to control profit margins giving the appropriate signals at a moment when additional investment was needed to facilitate Greece's entry into the European Community?

The Government's industrial policy, as outlined in the five-year plan for the period 1983-87, was aimed at improving competitiveness by overcoming the basic structural problems of the Greek economy, Mr. de Groote said. Firm determination by the authorities would be needed to implement those policies as a means of achieving their targets.

Another problem area, Mr. de Groote considered, was the agricultural sector. Tables 3 and 4 in SM/84/37 showed that investment in that sector had been declining in real terms since 1980. In view of the entry of Greece into the European Community, it seemed important that the trend should be reversed as a means of improving productivity, processing, and marketing.

There had been some tightening in monetary policy both in 1982 and in 1983, Mr. de Groote noted, leading to a deceleration of the rate of increase in the monetary aggregate, an increase in interest rates, and an improvement in the attractiveness of treasury bills. In addition, the authorities intended to allow greater flexibility in monetary affairs during 1984. The staff had mentioned that the strict controls on the financing of the government deficit had resulted in a sharp decrease, from 50 percent in 1981 to 7 percent in 1983, in the financing of the public sector borrowing requirement by the Bank of Greece. However, the analysis set out in Table 23 of SM/84/37 showed that the share of treasury bills and the Bank of Greece in financing the public sector borrowing requirement had been about 51 percent in 1980, 62 percent in 1981, and 55 percent in 1983. The only difference he saw was a decline in the share of the Bank of Greece and an increase in the share of treasury bills. Was that an improvement?

In that connection, Mr. de Groote went on, the reserve requirements of the banking sector depended largely on investment in treasury bills. When the banks made deposits to meet their requirements with the Bank of Greece, and the Bank of Greece then financed the government deficit, the position would surely be the same as at present. He had found very little information on the sales of treasury bills to the banking sector for private investors in recent years, although such information was vital to anybody wishing to know whether the monetary situation in Greece had improved. On the basis of the little information available, he suspected that there had been no increase in treasury bill purchases by the private sector, if only because the Government had put in place a whole array of measures to limit profit margins and there had been a general reduction in the demand for credit in recent years. In those circumstances, it would be unusual to see an increase in holdings of treasury bills by enterprises or households. Indeed, it was doubtful whether households even had access to treasury bills. He wondered therefore whether the imposition of reserve requirements on the commercial banks was not a cover for a further massive monetary financing of the Treasury.

There had been a rapid buildup in Greece's external debt during the past four years, Mr. de Groote commented. Despite its well-balanced maturity structure, the servicing of the external debt would become increasingly onerous in the next few years. In those circumstances, attempts to improve the balance of payments would be absolutely critical. He also agreed with the authorities that it would be desirable to strengthen autonomous capital flows by the adoption of additional policy measures. It might however be rather difficult to reconcile such measures with the rather dirigistic philosophy adopted by the authorities with respect to profits and profit margins. Finally, all members of his constituency wished him to express their best wishes for the success of the integration of the Greek economy into the European Community.

Mr. Clark said that he fully endorsed the staff appraisal. The figures for 1983 spoke for themselves: public sector borrowing represented over 13 percent of GNP and the current account deficit more than 5 percent; inflation was over 20 percent and the debt service ratio was nearly 17 percent and rising. Perhaps even more worrying was the disappointing lack of progress over the past few years. In the face of such imbalances the authorities' policy of gradualism was not appropriate. Although the targets for 1984 were modest, without a change in policy even they might not be achieved. There was therefore a need for a feeling of greater urgency.

Commenting on Greece's fiscal policy, Mr. Clark welcomed the measures that the authorities had taken to restrain public expenditure in 1984. He was particularly pleased by the emphasis placed on investment at the expense of consumption, although it would be important to ensure that the investments were fully cost effective. In passing, he would be interested to know how much of the investment was export oriented, and how import intensive it was. The measures to reduce tax evasion were also welcome, although it was uncertain how much extra revenue they would provide. But the targeted reduction of the deficit to 12.5 percent of GNP--a decrease of only some 0.5 percent--did not seem very ambitious. He agreed with the staff that there was a strong possibility of slippage, a point on which the past record, especially in regard to revenue, was not encouraging.

On the expenditure side, Mr. Clark endorsed the staff view that action needed to be taken to reduce the burden of the public sector enterprises. In 1983 their deficit on current expenditure alone had been over 13 percent of operating revenue. Including capital expenditure, the figure rose to over 52 percent--equivalent to some 4.7 percent of gross domestic product. Increased managerial efficiency, a reduction in overmanning, and selective price increases were all needed. Public sector wages represented 30 percent of all central government expenditure. The 24 percent rise in 1983 had significantly worsened the budget deficit as well as having wider effects. There seemed to be a clear need for great restraint in that field. On the revenue side, continued efforts would be needed to widen the narrow tax base. In addition, the introduction of a value-added tax would be useful.

Commenting on price and incomes policies in Greece, Mr. Clark remarked that the authorities had achieved notable success in restraining wage increases in 1983. Unfortunately, the policy for 1984 did not appear likely to maintain the progress; furthermore, it seemed only doubtfully consistent with the announced targets for inflation. Faster pay increases threatened to have serious effects on competitiveness. He agreed with the staff that the degree of indexation needed to be reduced, and he encouraged the authorities to consider modifying the index in the way that the staff had suggested. In addition, he wondered whether indexation should not take place annually, rather than every four months.

The increasing resort to price controls by the Greek authorities was worrying, Mr. Clark considered. Those controls were not likely to cure inflation in the long run; they would only lead to an increasing misallocation of resources. In combination with the wages policy, price controls had a severe effect on the profitability of industry. A recent survey of over 3,000 manufacturing companies indicated that some two thirds of them were recording losses. Until that situation was remedied, there seemed little prospect of arresting the decline in private investment. Nevertheless, the staff had reported in SM/84/21 that the Greek authorities considered current and prospective profits to be of secondary importance as determinants of investment. He asked Mr. Caranicas how such an attitude could be consistent with the authorities' expressed objective of fostering small businesses.

The slower growth of the monetary and credit aggregates in 1983 was encouraging, Mr. Clark considered. With the staff, he urged that it should continue through 1984, both to restrain inflation and to hold down imports. He welcomed the recent rises in interest rates, although more might be needed to encourage capital inflows. He also welcomed the authorities' measures to streamline the existing range of interest rates. Room remained, however, for further rationalization, and in particular for a reduction in the number of different interest rates.

Commenting on Greece's external policy, Mr. Clark observed that exports of both goods and services had been falling, that autonomous capital inflows had declined, and that there was evidence of disguised capital outflows. The current account deficit was unsustainable as the authorities recognized. He shared the staff's doubts about whether the 1984 target for the current account deficit would be achieved, in view of the prospective size of the fiscal deficit and the wage increases. If the target was to be achieved, it was likely to require an active exchange rate policy to dampen the effect of wage increases on competitiveness, and perhaps also a further rise in interest rates to encourage capital inflows.

He shared the staff's concern about the rise in foreign debt, which had amounted to over $1 billion a year since 1979, Mr. Clark mentioned. The staff's projection of a continuing rise in the debt service ratio to some 24 percent by 1989 was a major cause for anxiety, and that projection depended on a 16 percentage point rise in the proportion of the current account deficit covered by autonomous capital inflows; if those flows were not achieved, the position would be correspondingly worse. Furthermore, a weak and uncertain external position carried the risk of instability in short-term borrowing, a point for which no allowance was made in the debt service projections.

Greece's external reserves had been no more than the equivalent of five weeks of imports in November 1983, Mr. Clark remarked. He would be grateful if Mr. Caranicas would say what level of reserves the authorities regarded as adequate, and how they intended to work toward it.

If his remarks had been critical, Mr. Clark concluded, it was only because his authorities hoped that the Greek authorities would act in a timely fashion to reverse certain trends in the economy, which he believed they themselves recognized to be unsustainable.

Mr. Feito observed that the Government that had taken office in Greece in 1981 had inherited a difficult economic situation. Developments over the past two years had however not improved the situation greatly, and the authorities did not seem to have set in motion the corrective forces needed to redress the external imbalances in the economy. On the contrary, the room for a gradualist approach to bringing the economy back into equilibrium seemed to have narrowed considerably. For instance, despite the depletion of oil inventories and an improvement in the terms of trade, the deficit in the current account had risen relative to gross domestic product, and autonomous external inflows of capital had continued to subside. As a result, the balance of payments deficit had added to an already high stock of external debt, and it was worrying that the growth of the external debt over the period had not been accompanied by an adequate growth in the stock of productive assets in the economy. Instead, it had been associated with decreasing flows of capital formation, which put into question the sustainability of the external debt structure. The authorities would have to find a way of correcting the external imbalance while providing for increased capital formation as a means of servicing the external debt without unduly constraining consumption.

Both the continued decline in private sector investment and the deterioration in the external balance seemed to have been caused by the growth of the public sector deficit, increases in real labor costs, and the accompanying erosion of the competitiveness of the economy, Mr. Feito observed. Furthermore, uncertainty about the thrust of exchange rate and other economic policies might have had a bearing on both the poor performance of private investment and the drop in autonomous capital inflows. He therefore agreed with the staff in emphasizing the need to reduce the public sector borrowing requirement, to increase the competitiveness of the economy by a mix of exchange rate action and tighter financial policies, and to modify the indexation scheme so as to reduce its negative effects on profitability. In connection with profitability, he did not understand the sentence on page 11 of SM/84/21 to the effect that the authorities considered current and prospective profits to be of secondary importance as determinants of investment. In those circumstances, he would be interested to hear what the authorities considered to be the primary determinant of private investment. In the past few years, it seemed to have reacted quite predictably to the main factors governing profitability.

Current and prospective profits must have been seriously affected by the squeeze in private sector credit imposed by the growth of the public sector deficit, by the rise in labor costs, and by the real appreciation of the exchange rate. For instance, since 1975, the rate of credit expansion in the public sector had exceeded that to the private sector, and since 1981 the absolute growth in domestic credit to the public sector had been larger than that to the private sector. In addition, Chart 4 in SM/84/21 seemed to show that, although the increase in labor costs had declined since 1982, the real effective exchange rate was much higher than it had been in 1980. A combination of the factors he had mentioned might explain the fact that both the external and the internal imbalances in the economy were growing simultaneously and that the deterioration of profitability and competitiveness was a cause of both disequilibria.

The authorities were to be commended for the policy of income restraint that they had implemented in 1983, Mr. Feito went on. It would however be difficult for the authorities to control the growth of incomes in the future unless the stance of financial policies was tightened. While the strengthening of price controls might contribute to easing pressures on incomes, it could do so only temporarily and at the cost of considerable inefficiency. At the same time, the price control policy seemed to run counter to the central objectives of the authorities, namely, to improve competitiveness by raising the quality of national goods and services and to remove restrictions while providing for more equitable income distribution.

The Greek economy was plagued by structural imbalances whose elimination, the authorities well understood, was a necessary condition for achieving stable rates of growth and easing the external constraints, Mr. Feito observed. The authorities' determination to tackle the rigidities hindering the efficient functioning of the economy was highly commendable. However, their removal would require the long-term program to be carried out in an environment of macroeconomic discipline. Otherwise, there was a risk that the information communicated through the price system would not give rise to the allocation of resources desired by the authorities in the longer term.

Mr. Polak commented that he agreed with the authorities and the staff that inflation was the major problem in Greece, and that the maintenance of the current account deficit at its present level was unsustainable. In the circumstances, two questions ought to be asked: first, were the authorities' near-term targets likely to make acceptable results attainable over the medium term? And second, were the authorities' policies sufficient to enable them to achieve the near-term targets? The answers to both questions seemed to be in the negative. In the circumstances, he was not encouraged to learn from Mr. Caranicas that the Government's policies for 1984 would be essentially unchanged from those of 1983; and he did not agree with Mr. Caranicas that the targets were realistic within a context of gradual stabilization and noninflationary recovery. The same policies had not led to any reasonable lessening of internal or external imbalances during the past year; the staff's projections for inflation remained high, and the current account deficit seemed likely only to increase. He therefore had great difficulty in understanding how the same policies could be expected to be sufficient to attain even the very limited improvement at which the authorities were aiming in the near future. On the contrary, monetary, incomes, fiscal, and exchange rate policies were all inadequate to enable the authorities to achieve their objectives of stability and growth.

As to monetary policy, Mr. Polak stated, he noted that the authorities intended to increase the money supply by 22 percent in fiscal 1985, compared with 20 percent in fiscal 1984, in the face of very low expected real growth and inflation of 18 percent. He did not see how such a policy could be called nonaccommodating. The monetary authorities had made commendable efforts to contain inflation by a substantial reduction in monetary expansion in the past; but he saw no evidence of that policy continuing in 1984. Nor did he understand the authorities' view that the problem of inflation could be resolved without considerably tightening monetary policy, simply by waiting for a recovery in productivity. He had never been impressed by observers who blamed inflation on low productivity and other structural weaknesses in an economy. There were many countries that suffered from low productivity and other structural weaknesses, and yet maintained low inflation. From 1956 to 1970, Greece itself, for instance, had had lower inflation than most of the rest of Europe. Structural factors explained poverty; monetary factors explained inflation.

On the subject of incomes policy, he shared the doubts of the staff, Mr. Polak stated. It seemed unlikely that the present wages policy would be consistent with the lowering of inflation. One of the strongest pieces of evidence in that respect was the substantial increase in real salaries envisaged for all civil servants. As to fiscal policy, he not only doubted whether the 1984 target of a deficit of 12.5 percent of gross domestic product would make a medium-term solution possible; he doubted whether the target itself would be reached. One of the main weaknesses in the budget was that it assumed that there would be a reduction in the growth of interest payments from 50 percent in 1983 to no more than 8 percent in 1984.

Commenting on Greece's exchange rate policy, Mr. Polak observed that on page 12 of SM/84/21 the staff had written that "the authorities noted that a compromise had to be struck between the objectives of strengthening the balance of payments and reducing inflation." It would have been more appropriate to write that the authorities had so argued. Without any other policy in place to reduce inflation, overvaluing the currency would not bring about external equilibrium. The proper procedure for the Greek authorities would be to assign the exchange rate strictly to the balance of payments, and to attack inflation with other policy instruments. As far as inflation was concerned, the aim must be to reach harmonization with other members of the European Community.

Discussing methods of tackling the current account deficit, Mr. Polak said that he had some doubts about the merits of a formula treating nondebt capital inflows as percentages of the current account deficit. There did not seem to him to be any link between the two variables. Both the staff and the authorities seemed to imply that there would be declining amounts of nondebt capital inflows; but he doubted whether they could materialize at all unless the authorities introduced a considerably tighter monetary policy and higher domestic interest rates.

In conclusion, Mr. Polak observed, the Greek authorities seemed too optimistic about the benefits that could accrue from an upturn in the world economy; too optimistic in their view that the main problems could be solved in the medium term by means of very gradual improvements; and too optimistic that their moderate targets for 1984 would be realized by the policies so far adopted.

Mr. Finaish stated that it was evident that Greece had been going through a difficult period, characterized by continued low growth, persistent financial imbalances, and marked structural weaknesses. However, the authorities had recognized the need to give priority to stabilization. In 1983 their policies had sought to contain inflationary pressures, in part through a tighter incomes policy, while aiming at a resumption of output growth. The adjustment efforts during the past year had enabled the authorities to achieve some of their policy targets. As the staff had noted, they had somewhat improved their control over central government expenditures; they had brought about a deceleration in the growth of broad money; and their incomes policy had contributed to moderating the rise in unit labor costs, while recording some gains in productivity.

However, insofar as improving the growth of the economy and reducing financial balances was concerned, progress had been below expectations, Mr. Finaish remarked. The staff paper had usefully highlighted the areas where policies needed to be strengthened in the period ahead. The authorities seemed generally to concur with the staff on the desirability of trying to improve central government finances, reduce the deficits of public sector enterprises, reform the tax system, and strengthen the roles of exchange and interest rate policies. It was basically on the pace or adequacy of adjustment, rather than on the need for adjustment itself, that there appeared to be some difference of view between the authorities and the staff. The authorities' preference for a policy of gradual adjustment was understandable in the light of the constraints facing them. In particular, the successful reorganization of the industrial sector that was required by the challenge of Greece's membership in the Economic Community and the need to foster import competitiveness involved structural reforms that could only be phased in over an appropriate period. However, the authorities could consider introducing supplementary corrective measures if the attainment of their stated short-term policy targets so required. The achievement of those targets would strengthen the credibility of the Government's policies, and underscore its commitment to the adjustment process.

In the matter of foreign borrowing, the staff had indicated on page 85 of SM/84/37 that in recent years there had been a rapid buildup in Greece's external debt, and a noticeable increase in the debt service ratio. Such developments underlined the importance of careful external debt management, which, in conjunction with other demand management policies, should contribute to containing the debt burden and preserving the authorities' freedom of maneuver in coming years.

With regard to Greece's energy policy, Mr. Finaish noted from page 11 of SM/84/37 that since 1981 there had been a shift from stockpiling petroleum to destocking. The staff had written that "while in 1981 there had been a large stockpiling of petroleum products, increasing the net oil bill to $2.9 billion, the new Government reduced these stocks in both 1982 and 1983; this helped reduce the net oil bill to $2.1 billion in 1982 and to an estimated $1.7 billion in 1983." Those figures provided an indication of the addition to the oil bill entailed by large-scale stocking. The staff had also written that, despite the recent destocking, Greece's oil stocks still exceeded present needs, which were 90 days' supply, the minimum required by the regulations of the European Community. The costs involved in oil stocking were reflected in the domestic financial aggregates and the external balance. In that connection, the staff had written in SM/84/21 that during 1983 the sizable deceleration in the growth of the monetary and credit aggregates had been attained in part through the reduced borrowing requirement of the Consumer Goods Account to finance petroleum stocks. In other words, policy changes with respect to oil stocks could have significant indications for monetary and fiscal policies, at least in the short run. It would therefore be useful if the staff could elaborate further on the macroeconomic implications of changes in oil stocks in the light of Greece's experience of recent years.

Naturally, Mr. Finaish went on, the question of accumulation of oil inventories through imports was not confined to any one country; it was a more general one. Such an accumulation had important implications that needed to be considered carefully. Stockpiling of oil not only gave rise to unnecessary costs for importers; there was also a speculative dimension to it that could create an atmosphere of suspicion between the exporters and importers, and destabilize the oil market. Inasmuch as stockpiling was meant to mitigate the disruptive effects of possible unforeseen interruptions in the supply of imported oil, it would be better if efforts were made to minimize the possibility of such interruptions through longer-lasting and less expensive means.

Mr. Blandin remarked that without doubt the Greek authorities were facing serious economic problems, which had been frankly described by both the staff and Mr. Caranicas. The task of the present regime was all the more difficult in that most of the problems had either been inherited in the past or were due to an unfavorable economic and financial environment. Structural weaknesses were clearly interfering with any treatment of short-term imbalances. He agreed with the Greek authorities that a gradual approach was the only appropriate way in which to tackle the severe problems facing the economy. Nevertheless, the authorities were facing constraints that might require strong action to be taken rapidly. Consequently, he agreed with the staff that the Greek authorities' targets for 1984 ought to be more ambitious.

The arguments in favor of a gradual approach had been well made by Mr. Caranicas, Mr. Blandin remarked. Clearly, some elements in the present economic situation were of long-standing origin, failure to adjust to the second oil shock having led to a deficit on the current account of nearly 6.5 percent of gross domestic product. At the same time, private fixed investment had climbed strongly, endangering the competitiveness of the economy; and an inflationary atmosphere had developed that would be difficult to dispel. Such problems could not be overcome even in a year or two. He therefore agreed with Mr. Caranicas that, with a rather limited room for maneuver in the short run, the Greek authorities were compelled to try to bring the economy back on to a noninflationary growth path in a gradual fashion. At the same time, they needed to tackle the structural problems by modernizing the economy, improving cost competitiveness, and broadening the export base, although the time for so doing was rather short because of Greece's entry into the Economic Community (EC).

However, Mr. Blandin continued, even if they had achieved some modest successes, the Greek authorities would have to tackle forthwith two major constraints--the external debt and the rate of inflation. From 1979 to 1983 the external debt had more than doubled to reach 27.3 percent of GNP. At the same time the debt service ratio had increased from 11.6 percent in 1980 to roughly 17 percent in 1983. Inflation in Greece was running at some 20 percent, a higher figure than was found in any of Greece's main trading partners. In those circumstances, the rate of price increase was clearly unsustainable, especially as other EC countries had adopted strong anti-inflationary policies. In the short term it seemed unlikely that a constant depreciation of the drachma would offset the domestic price differential of Greek industry, since any temporary gains were likely to be eroded by increases in wages and lack of response from domestic manufacturers.

In view of the marked structural weakness in the economy and the constraints he had mentioned, he could agree with the staff that the authorities ought to set more ambitious targets for 1984, Mr. Blandin observed. Two points needed special attention, as they were the key to re-establishing financial equilibrium. Although he could agree with the staff that the principal area of concern was the balance of payments deficit, in fact the principal cause of disequilibrium in the current account balance was the budget deficit. Close attention should therefore be given to the public finances. Although the Greek authorities had had some encouraging successes, the main difficulties seemed to be the inelasticity of direct taxes which, as the staff showed in SM/84/37, had decreased as a proportion of total central government revenues from 29 percent in 1980 to 26.9 percent in the projected budget for 1984. Moreover, the ratio of total revenue to GDP had declined from 1979 to 1983. The intended reform of the tax structure and the enlargement of the tax base, together with the special emphasis placed on income taxes and the avoidance of tax evasion, were therefore welcome.

Nevertheless, Mr. Blandin considered, there would have to be some tightening of expenditure control, at least in the initial stages. The reduction in the rate of increase in government expenditure to 10 percent in 1984 from 33 percent in 1983 was certainly commendable. Meanwhile, the substantial overshooting representing nearly three times the projected deficits for the public enterprises and other entities recorded during the past year should be eliminated, and financial discipline should be introduced into their operations.

The second area of concern, Mr. Blandin remarked, was labor costs; their rise was certainly responsible for the loss of competitiveness of Greek products as well as for inflationary expectations. He would therefore stress the crucial role of incomes policy in Greece. In 1983 the authorities had been rather successful; the partial deindexation for higher-paid workers had made it possible to lower the average increase in wages as a whole. Nevertheless, he was rather disturbed by the outlook for 1984. The provision for a nominal increase in public salaries and pensions of nearly 24 percent--or 6 percent in real terms--in the 1984 budget was worrying. He wondered whether such a proposal was compatible with the aim of reducing inflation. In a number of fields the authorities would have to tighten their gradualist policies in the next few months. His chair understood very well that such a course might be difficult; the path toward recovery and sustainable growth was nearly always arduous, as several Fund members not far from Greece had reason to know. Nevertheless, he would encourage the Greek authorities to persevere along that path.

Mr. Doe remarked that the economic difficulties and financial imbalances experienced by Greece during the past few years had been rather serious. Industrial production had declined since 1981, after a marginal increase in 1980. Agricultural output had stagnated, reflecting structural maladjustments, low productivity, and the effect of Greece's entry into the European Community. The weak industrial and agricultural performance, together with a severe deterioration in the net inflow of factor income, had more than offset the small increase in the services sector. As a result, real GNP had fallen during 1981-82. The financial imbalances were no less serious. During the period 1979-83 the rate of growth of expenditure had on average been some 9 percentage points of GNP higher than the increase in revenue. The result had been the emergence of a relatively large financing gap, which had been covered essentially by an accommodating bank credit policy. The external sector had remained weak, with the debt service ratio rising by nearly 6 percentage points over a five-year period.

Meanwhile, Mr. Doe went on, during the period 1979-83, the increase in the consumer price index had ranged from about 19 percent to about 25 percent, and the increase was only 1 percentage point less when inflation was measured in terms of the increase in the GDP deflator. The rate of inflation was therefore quite high by the standards of economies with resource endowments comparable to those of Greece. In the circumstances, it was appropriate to call for the vigorous implementation of a coordinated set of policies designed to eliminate the structural imbalances that had contributed so greatly to inflation. The key to any adjustment would be less expansionary fiscal and monetary policies. An appropriate wage policy would be central to any effort to root out inflationary expectations. He would therefore urge the Greek authorities to show the same restraint in 1984 and beyond as they had shown in 1983, if they wished gradually to make the cost structure of productive units viable once again and to restore the competitiveness of goods and services. In that connection, he had heard Mr. Caranicas say that the Government intended to take measures aimed at ameliorating the cost competitiveness of the productive units in the context of the five-year development plan. He would welcome further information from Mr. Caranicas or the staff on the specifics of those measures. As to pricing policy, he agreed with the Government that oligopolistic practices could have unfavorable effects on producers as well as on consumers. In the course of rooting out those practices, he hoped that incentives to produce would be preserved. Investment decisions would certainly be taken more easily if enterprises had comfortable internally generated financial resources.

Commenting on Greece's fiscal policy, Mr. Doe considered that the relatively large imbalance between revenue and outlays needed to be addressed effectively. In view of the limitations on revenue expansion, a determined effort should be made to contain the growth of spending, which had increased in 1983, following a significant decline in 1982. Serious consideration should be given to the staff recommendation that the authorities should ensure that wage policy played a restraining role as part of a coherent overall macroeconomic policy for demand management and the enlargement of supply.

To that end, Mr. Doe concluded, he would urge the Greek authorities not to delay the adoption and implementation of the policies needed to restore viability to the economy. Less reliance should be placed on the expected favorable effects that could arise from an upturn in the world economy, which should not be considered a substitute for policy changes.

Mr. Tvedt said that he agreed with the staff appraisal. While a gradual approach might be appropriate in tackling certain structural problems, it might prove a difficult one to follow in dealing with the whole spectrum of problems facing the Greek economy. A determined adjustment effort with strong momentum was needed, and it did not seem to exist in Greece at present. Unless some momentum was generated, there was a danger that the problems would become self-perpetuating.

Inflation might be the most pressing problem facing the authorities, Mr. Tvedt considered; it seemed to be the major cause of difficulties in different parts of the economy. In view of the persistence of a rigid system of indexation, inflation was unlikely to decline. Consequently, a review of the indexation mechanism would be in order.

As long as inflation remained high, he would strongly recommend the adoption of a flexible exchange rate policy aimed at a stable level of competitiveness, Mr. Tvedt observed. Aside from causing problems for export industries, a rigid exchange rate policy or one of only occasional changes could easily generate waves of speculative import demand. The maintenance of competitiveness should of course take priority over any perceived importance that might be attached to the dollar/drachma rate.

Although he could applaud the noble idea of compressing wage differentials through the indexation mechanism, Mr. Tvedt stated, he feared that in due course such a policy would lead to an unintended wage drift in the upper brackets of the wage scale, thus running counter to the Government's policy. The external position should be strengthened considerably, and that could only be achieved through a marked tightening of fiscal and monetary policies together with the adoption of a flexible exchange rate policy.

Finally, Mr. Tvedt said, postponements of wage adjustments--such as had been tried in 1983--only had limited short-lived effects on inflation, as they did not address the problem itself. The authorities needed to strengthen their adjustment resolve and to design an effective incomes policy. As his chair and others had often remarked, incomes policies could only be effective if they went hand in hand with determined monetary and fiscal policies. Furthermore, for incomes policies to be effective, the whole program should yield quick and tangible results, a conclusion that made him feel that the gradual approach of the Greek authorities might be too weak and that, even if given time, it might well never bring the desired results.

The staff representative from the European Department, replying to questions, recalled that Ms. Bush had inquired whether the investment incentives were sufficient, since the resumption of growth and employment would depend heavily on incentives to invest in both the public and private sectors. The Greek authorities did not believe that profits were particularly important as a stimulus to private investment. Naturally, private entrepreneurs might have a rather different view. The authorities considered that it was essentially the growth of demand that would stimulate investment. She herself certainly doubted whether there were adequate investment incentives for investment at the present time. The framework for decision making was said to have been stabilized by the law on investment incentives, but she was not convinced that that was indeed the case. For instance, the intention of the authorities further to tighten price controls--which had been recently announced in conjunction with the 1984 incomes program--might well serve to discourage investment. It was difficult to say whether public investment had crowded out private investment because so far public investment had taken the form of infrastructure, such as hospitals, roads, and telecommunications. The only commercial project of which she was aware that had been undertaken by the Government was in the aluminum sector. It was not so much public investment as the lack of certain other policies that might discourage private investment.

The point that profits were being squeezed had been raised by Mr. de Groote, the staff representative noted. She agreed that the indications were that profits were being very greatly squeezed. A rather large number of enterprises were reporting losses, although it was difficult to know how firm the reported figures were. Other calculations based on changes in unit labor costs and value added in manufacturing also suggested that a very significant profit squeeze was taking place. Her own belief was that over the past two to three years the profit situation had deteriorated significantly. Commenting on the observation that investment in the agricultural sector had been depressed for the past three years or so, the staff representative remarked that the greatest decline had occurred in 1980; since then the fall had been rather moderate. Perhaps of greater significance for those concerned with the balance of payments was the decline of investment in industries, and particularly in manufacturing. The cumulative decline during the past two years had been approximately 15 percent.

Replying to Mr. Finaish's comments on energy policy, the staff representative recalled that the destocking of petroleum products in Greece had been a great help in reducing the disequilibrium in the balance of payments. It had also reduced the carrying cost for the energy stocks. However, since destocking was admittedly a once-and-for-all adjustment, it was not at all clear what the macroeconomic implications of the reduction were. The Greek authorities estimated that present stocks were equivalent to some 115 days of consumption, although the figure was open to question.

A number of speakers had commented on the stance of monetary policy, the staff representative said. It was difficult to judge the policy for 1984 because a number of institutional changes were involved. In addition, the Greek authorities intended to review their policy every three months against the background of domestic and external developments. Perhaps the major institutional change was the opening up of treasury bills for purchase by domestic households and public entities. In the past, treasury bills had been held exclusively by commercial banks and, to a very limited extent, by the Bank of Greece. The new measures would make the dependence of the Central Government on credit from the commercial banks and the Bank of Greece very much less, but they had not yet been adopted. Another factor that made it rather difficult to judge the authorities' policies for 1984 was the rate of inflation. If the rate of inflation were to be 18 percent, the policy for 1984 seemed to be fully accommodating; but if it were assumed that the rate of inflation would be 20 percent or 21 percent--a figure that could easily be reached after the adjustments in real wages foreseen during the year--policy would be more restrictive. The increase in interest rates for treasury bills was to be welcomed, although it would certainly give rise to a much larger domestic debt servicing burden for the Government.

Commenting on the authorities' incomes policy, the staff representative recalled that wage agreements in the private sector had been announced only within the past several days; it now seemed very likely that the increase in wages in the private sector would be similar to that in the public sector, a fact that cast doubt on the likelihood that the rate of inflation would be no more than 18 percent in 1984. The staff had discussed with the authorities the possibility of altering the indexation system. But, although the authorities had said that they would consider possible modifications, they had announced the same system with no adjustments for changes in administered prices or exchange rate movements. Mr. Tvedt had noted that the compression of wage differentials might have a severely adverse effect on the development of wage drift.

In 1983, real wages had been held down considerably by the incomes policy, and there had been substantial compression; it had also been estimated that wage drift had been between 3 percent and 4 percent in that year. Further compression would of course give rise to further drift. It was also possible that, because of the underground economy in which many workers had second jobs, incomes were not being held down as much as would be suggested by the existence of the indexation system.

The increases in administered prices were in themselves causing problems, the staff representative remarked. While the staff had mentioned that the exchange rate had to be viewed in the light both of external competitiveness and of its implications for domestic price developments, the adjustment of administered prices had also to be viewed not only from the standpoint of the profitability of public enterprises but also from that of the implications for inflation. It was certainly true that administered price increases tended to be held down when the Government wished to restrict the rate of price increase; consequently, on occasion the consumer price index might actually understate the underlying rate of inflation.

On the topic of Greece's fiscal policy, the staff representative said that it was clearly important to concentrate on expenditure control in the budget for both current and investment expenditures. In 1984, according to the budget there would be virtually no increase in current expenditures in real terms. However, staff calculations suggested that the provision in the budget for debt service payments and other nonwage expenditures might not be adequate. The additional resources required for those purposes might exceed the capacity of the reserve fund set up to cover such a contingency. In consequence, further tightening in other areas of the budget might be needed. On the revenue side, there was clearly a great need to expand the revenue base, although perhaps not to increase the rates of taxation. Farmers, for instance, were almost exempt from taxation, being assessed a 2 percent tax on agricultural production--which was apparently rarely paid. As part of the five-year plan the exemption would be reviewed, but at the present time there was no intention to expand the tax base to include farmers. There were a number of other discrepancies, such as the exclusion of football players from taxation and the grant of double deductions to journalists.

There were significant problems of overmanning in the public enterprises, the staff representative mentioned; yet employment in the public sector seemed likely to increase marginally in 1984 rather than to decline. Furthermore, if the public sector enterprises were to pay interest charges, their operating surplus (excluding interest payments) would have to rise from some Dr 30 billion to about Dr 50 billion, and it was not clear that the increase in administered prices would provide the additional Dr 20 billion.

As to the relationship between the balance of payments situation and the external debt, it was true that both were symptoms of underlying imbalances, the staff representative remarked. Both the staff and the authorities paid great attention to the situation, which had become very worrying, particularly in view of the need to borrow some $1.5 billion for reasons described by the staff in SM/84/21 and SM/84/37. The likelihood of an improvement in the external position over the next two years was not particularly great. In fact, the Greek authorities had assumed that the current account deficit would remain in the neighborhood of $2 billion for 1984; using an exchange rate that would reflect the maintenance of a constant real exchange rate in 1984, the figure would rise from 5.4 percent of GNP to almost 6 percent of GNP.

Discussing the question of whether Greek tourism was competitive with that in countries such as Portugal and Spain, the staff representative said that she had reviewed the matter with the authorities and that they had argued that the indices used by the staff, based on consumer prices, were inadequate. According to the Greek authorities the proper way of examining the competitiveness of tourism was to take the cost of complete packages; on that basis Greece was more competitive than other European countries. In fact, tourist arrivals in Greece in 1983 were very little less than in 1982. Nevertheless, foreign currency receipts had fallen substantially, perhaps indicating the presence of disguised capital flight brought about by the fact that interest rates on savings were less attractive in Greece than they were elsewhere. While the point had been addressed to some extent by recent monetary measures, additional capital inflows in the form of foreign direct investment would be helpful, and the authorities had mentioned that they had had a number of applications for investment of that sort. They had taken measures to facilitate the processing of such capital inflows, but it was not yet known whether the number of applications would rise very greatly.

A comment had been made about the way in which the staff had calculated autonomous capital inflows as a percentage of the external deficit, the staff representative from the European Department recalled. Looking at the matter in absolute terms, the proportion of the deficit that could be covered by capital inflows in the next year or two was unlikely to be more than 50 percent or 55 percent. Capital inflows had amounted to some $1 billion a year for the past three to four years, and the authorities had estimated the deficit to be in the neighborhood of $2 billion a year. In those circumstances, as Mr. Clark had observed, Greece's reserves were very low, amounting to no more than five weeks of imports. A number of swap lines were available to the Greek authorities, who had in fact not made use of them because they had been able to restrict imports by the use of the licensing system. They had not indicated what their targeted level of reserves might be, or how they would go about attaining that level.

Mr. Caranicas remarked that there seemed to be a thread of unanimity in the comments of the members of the Board regarding some of the policies of his authorities, particularly on whether their plans were ambitious enough and their monetary policies accommodating. Convergence of views did not mean that his colleagues' views were any more valid for that. In any event, the consultation with the staff had been cordial, and the Greek authorities greatly appreciated the work of the mission and the candid way it had given its views and advice.

The Government maintained, Mr. Caranicas continued, that its economic policy stance for 1984 did not differ from that of 1983. In particular, fiscal policies in 1984 would be somewhat less expansionary, with volume increases in public consumption and public investment at rates of 1 percent and 9.5 percent, respectively, compared with 2.5 percent and 14.3 percent in 1983. The net public sector borrowing requirement was estimated to be 12.6 percent of GNP in 1984 as against 13.2 percent in 1983.

He thought one should not underestimate the progress made and the objective difficulties surrounding the stabilization of the economy, Mr. Caranicas stated. He also believed that monetary policies were not accommodating in 1983 and would not be so in 1984. Domestic credit expansion was to be about 19 percent in 1984 compared with approximately 20 percent in 1983. The rates of credit expansion to the private and public sectors in 1984 were projected at 18 percent and 20.7 percent, respectively, compared with 17 percent and 23.4 percent in 1983. Bank deposit rates and interest rates on treasury bills were being increased. In view of the record hitherto, the Government believed that it was unreasonable to doubt the achievement of the 1984 policy targets or the general direction in which the policies were moving.

A major factor in the decline of private investment in recent years, Mr. Caranicas remarked, had been the expansion of the manufacturing sector in a well-protected environment, with rapid growth of domestic demand. Further, beginning in the late 1960s Greece ceased to be able to rely on an elastic supply of labor, and expansionary policies had led to rapid increases in labor costs. Currently, total fixed investment was expected to increase marginally after declines for three consecutive years.

Business investment had been depressed in 1983, Mr. Caranicas said, the factors responsible for that weakness being the sluggish growth of sales and output, excess capacity--also responsible for the weakness in industrial investment--and depressed profits. The increase in industrial production, quite perceptible late in 1983, would lead to higher rates of capacity utilization and induce a later increase in investment.

Two primary areas of uncertainty were seen with regard to investment, Mr. Caranicas mentioned. First, a number of projects were being undertaken by government agencies; no definite information was available on capital appropriations and the rate of implementation. Second, under the new incentives law a number of applications had been processed; it was unknown how long the gestation period would be before the investments would actually be forthcoming.

Concerning the point raised by Mr. de Groote on profits as a determinant of investment decisions, Mr. Caranicas remarked that at present profitability might be reduced by the carry-over effect of the wage increase in previous years. However, the containment of labor costs achieved in 1983 and, it was hoped, in 1984 would have a cumulative effect that--together with the improvement in the external environment--might become apparent by the end of the year. The only areas in which some progress could be expected earlier were new industrial projects furthered by the law on investment incentives designed to restructure the industrial base toward export orientation and the introduction of new technologies. That type of investment was not demand-led but fiscally induced.

A number of speakers had referred to an article that had recently appeared in the Wall Street Journal, Mr. Caranicas remarked. It was worth noting that the Greek Minister of National Economy, while visiting New York, had explained Greece's economic policies and the country's foreign capital investments. The Government was prepared to give guarantees and negotiate certain conditions, providing that private investment from abroad promoted the aims of the five-year plan in line with the government targets for 1984.

Replying to Mr. Finaish's question regarding Greece's energy policies, Mr. Caranicas explained that the reduction in oil stocks had taken place for two reasons. First, in the past 18 months domestic oil production had reached capacity levels and at present covered 12-15 percent of domestic consumption. There had therefore been less need to maintain large oil stocks. Second, prudent stock management dictated that destocking should occur when prices fell, as had recently been the case. Of course, destocking had also helped the balance of payments.

More generally, the authorities maintained that gradualism was essential in the present political and social circumstances, although they did understand that there were a number of risks involved, Mr. Caranicas stated. They were also taking into account the current recovery in industrial countries. It had been recognized by a number of speakers that there were a number of special constraints in Greece that did not perhaps apply in other members of the European Community. The Government wished to proceed slowly so as to avoid stumbling blocks that might otherwise prevent them from making reasonable economic and social progress. He would transmit to his authorities the views of the Executive Board, as well as the summing up that the Chairman was about to make; they attached great importance to both the individual and the collective views of the Executive Directors.

The Chairman remarked that Mr. Caranicas seemed to think that the staff had been rather stiff in its formulation of the appraisal. He hoped that Mr. Caranicas would inform his Greek authorities that the language used by the staff had been much milder than that which would be found in the summing up resulting from the present discussion. The Executive Directors had been much more forthright than the staff.

Thereupon, the Chairman made the following summing up:

Executive Directors stressed the seriousness of the problems that beset the Greek economy. In addition to the recession abroad, the external balance was burdened by a number of important structural problems in the economy. While noting the Government's intention to redress these problems in a gradual manner, Directors considered that the severity of internal and external imbalances necessitated a more rapid adjustment than was currently foreseen.

Directors agreed with the authorities that the current account deficit could not be maintained at its present level if foreign borrowing were to be kept at a sustainable level. A number of Directors expressed concern that, despite both continued slow economic growth and temporary favorable factors, the current account deficit as a share of GNP had increased to nearly 5.5 percent in 1983, and the errors and omissions item had become heavily negative. Even assuming favorable developments with regard to merchandise exports and earnings of invisibles--which had declined markedly since 1981--the current account deficit was likely to rise to 6 percent of GNP in 1984. A number of Directors questioned whether the authorities would be able to reduce the deficit to the target of 3.25 percent of GNP by 1987 without much more decisive policy action than currently envisaged to increase significantly the competitiveness of Greek products. It was also noted that the authorities' assumptions concerning the level of external nondebt financing seemed optimistic; the realization of these autonomous inflows would depend to a large extent on the pursuit of appropriate policies, especially with regard to interest rates. In this context, Directors expressed serious concern regarding the external debt situation and the likely substantial increase in the debt service ratio in coming years. It was noted by several Directors that the country's level of reserves had fallen to the equivalent of less than five weeks of imports and that Greece's standing in external markets could come under question. In these circumstances, a number of Directors considered that a flexible exchange rate policy combined with a strong anti-inflationary domestic demand management policy would be an essential element of a comprehensive strategy aimed at prompter external adjustment.

In the field of monetary policy, most Directors commended the authorities on the steps which had begun to be taken to increase financial discipline. A few of them noted the intention of the authorities to reduce further the rate of domestic credit expansion in 1984, although several speakers considered that monetary policy was still accommodating too high a rate of inflation. Many welcomed the recently announced increases in interest rates on bank deposits and on treasury bills. However, it was stressed that unless there were a very sharp deceleration in inflation most rates would continue to be negative in real terms, and the authorities were urged to utilize greater flexibility in the field of interest rates. There was general agreement that greater unification of the structure of interest rates and a further move toward positive real interest rates would be desirable both from a domestic and from an external perspective.

As a result of large fiscal overruns in both 1982 and 1983, there had been only a small reduction in the net public sector borrowing requirement from its peak of 14 percent of GNP in 1981. Several Directors noted that the target borrowing requirement for 1984 was substantially higher than the targets for 1982 and 1983 and represented only a modest goal compared with the outturn for 1983. Concern was expressed that in the absence of supplementary measures, the target might not even be achieved. Directors generally agreed with the staff assessment that the growth of both ordinary and investment budget expenditures should be carefully monitored and that the authorities should review as soon as possible the numerous tax exemptions currently granted to important sectors of the economy with a view to expanding the tax base. Many encouraged the authorities to introduce the value-added tax on schedule.

Directors noted that the restrictive stance of incomes policy in 1983 had contributed to a lower rate of growth of unit labor costs. They stressed that continued wage restraint would be required in order to improve the international competitiveness of the Greek economy, and pointed to the inflation differential between Greece and its major trading partners, which remained very large and which, since January 1983, had been only partly offset by exchange rate movements. A number of Directors expressed concern that the recently announced incomes policy for 1984, officially estimated to give rise to an increase in real wages in the public sector of up to 6 percent, might have important consequences for private sector wage settlements and jeopardize the targeted reduction in the rate of inflation. In this respect, Directors expressed the view that the system of wage indexation should be modified along the lines suggested by the staff and that wages should be adjusted less frequently. A number of Directors also wondered whether the Government's announced intention of tightening price controls might not give rise to additional distortions and discourage investment by introducing further uncertainties for economic decision making. A revival of investment was seen to be essential for the creation of adequate employment opportunities and the re-establishment of external balance. In this regard, concern was expressed about the steep drop in private investment in recent years. Directors underlined the seriousness of the losses of profitability in large sectors of the Greek economy.

In sum, most Directors considered that the seriousness of the present problems was such that more rapid and decisive adjustment action was required. The targets set for 1984 by the Government seemed inadequate and were not likely to be fulfilled by the present policies.

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

The Executive Board then took the following decision:

Decision Concluding 1983 Article XIV Consultation

1. The Fund takes this decision in concluding the 1983 Article XIV consultation with Greece, in the light of the 1983 Article IV consultation with Greece conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund welcomes the elimination of the advance import deposit requirements on January 1, 1984. The Fund notes that Greece continues, pursuant to Article XIV, to maintain restrictions on payments and transfers for current international transactions, as described in SM/84/37.

Decision No. 7630-(84/26), adopted
February 17, 1984

2. LAO PEOPLE'S DEMOCRATIC REPUBLIC - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with the Lao People's Democratic Republic, together with a proposed decision concluding the 1983 Article XIV consultation (SM/84/30, 1/27/84). They also had before them a report on recent economic developments in Lao (SM/84/38, 2/3/84).

Mr. Ismael made the following statement:

The main objective of the Lao authorities is to promote agricultural and forestry sector development by improving the physical and marketing infrastructure and by ensuring the adequacy of incentives. The government and state enterprises play a key role in achieving the economic and social objectives laid down in the Development Plan, 1981-85. The role of the private sector in the development process is somewhat limited. It is the policy of the authorities to make the private sector play a more active role in the development process than has been the case hitherto.

The Lao economy has made considerable progress in recent years in spite of the severe and prolonged world economic recession, internal and external transportation difficulties, shortages of foreign exchange, and shortages of skilled manpower. The average growth in real GDP over the last few years has been about 4 percent, which is better than what many other developing countries have managed to achieve. Considerable progress has been made in rice production, which has increased by about 30 percent in the last four years. As a result, the Lao P.D.R. has now achieved self-sufficiency in foodgrain which in the previous years was in short supply. Progress has also been achieved in animal husbandry and the production of several other agricultural products. While industrial production has shown a significant growth because of a higher level of electricity generation, the industrial base continues to be very narrow, and its expansion is likely to be slow. The country, however, has a tremendous potential for increasing and diversifying agricultural and forestry products as well as for exploiting its mineral and hydroelectric power generating potential. Development in these areas would require the inflow of substantial foreign capital, modern technology, and technical assistance; otherwise development may take a long time.

The progress in budgetary performance in recent years has been very impressive. In 1982 for the first time a surplus was achieved in the Government's operating budget and a public savings equivalent to 4.3 percent of GDP was achieved. Further measures were introduced in 1983 which resulted in higher revenues from turnover taxes and from taxes on industrial and commercial profits. Expenditures also increased, mainly on account of higher costs of materials and increased salaries for civil servants. These cost increases were partially offset by a reduction in the size of the civil service. The overall budget deficit declined from an equivalent of 24 percent of GDP in 1982 to 18 percent in 1983. This indeed is a commendable achievement. It may be questioned whether a fiscal deficit of 18 percent of GDP is excessive. It would be my submission that for a centrally planned economy where much of the production, distribution, as well as the developmental responsibilities are in the hands of the Government, a deficit of the order of 18 percent of GDP cannot be considered excessive, especially when one takes account of the fact that the entire deficit is financed from foreign assistance. In other words, a fiscal deficit of the order of 18-20 percent is necessary to absorb the inflow of foreign assistance.

The public enterprise sector plays an important role in the economy and its recent performance has generally been satisfactory. It is heartening to note that none of the enterprises incurred any losses in 1983. The good performance of public enterprises has resulted from measures introduced by the authorities to improve productivity and financial performance. Among the measures introduced were the decentralization of decision making on investment, production, and foreign marketing; the decision to allow enterprises to retain 40 percent of their profits; the decision to allow enterprises to reward workers on the basis of productivity; and the acceptance of the need to allow greater flexibility in prices to take account of cost developments. These reforms are likely to result in further improvements in the efficiency and profitability of state enterprises.

Performance has not been very satisfactory in the area of prices. Official retail prices increased by 52 percent in 1982 and by 39 percent in the first three quarters of 1983. These large increases in retail prices were a direct result of increases in procurement prices and the desire of the Government to contain rapid growth in consumer subsidies. It is hoped that improvement in incentives arising from higher procurement prices will result in greater production and a lower level of prices. Another factor contributing to the high inflation rate is the rapid growth in total liquidity of about 50 percent annually in the last two years. The major source of liquidity growth has been credit by the banking system to state enterprises. With improvements in the efficiency of state enterprises and the decision to allow enterprises to retain 40 percent of their profits, it is expected that credit needs of the enterprises could ease somewhat.

Another area of concern is the prospects for the balance of payments. A substantial part of the current account deficit is being financed by foreign aid, and in the last three years the deficit in the overall balance has been in the range of $4-5.5 million, not a large sum in absolute amount. Nonetheless, when considered against the low level of foreign reserves, deficits of the order of $15-20 million, projected for 1984 and 1985, are clearly not sustainable. In these circumstances, the Lao authorities will have to devise measures to improve export incentives, to curtail the import budget, and to arrange additional foreign assistance.

In conclusion, I wish to note that preparing an economic report on a country such as the Lao P.D.R. is no mean task. The report demonstrates the considerable ability of the staff to improvise in the circumstances where the data base is weak and where different economic concepts are used. I wish to join my authorities in expressing our deep appreciation to the staff for its thorough and balanced report on the Lao economy.

Mr. Morrell endorsed the staff appraisal and supported the proposed decision. The Lao P.D.R. was a country that suffered from a number of handicaps, including mountainous terrain, difficult and often inadequate transportation, sparse population, and a location in a rather troubled part of the world. The country had one of the lowest per capita gross national products in Southeast Asia, and between 80 and 85 percent of the population was engaged largely in subsistence agriculture. Following several years of reasonable growth, the Lao economy had remained stagnant in 1982 and 1983 as a result of both poor weather conditions and a halt in the reclamation of arable land. Inflation had been high for a number of years caused, or at least accommodated, by the equally rapid growth of credit and liquidity. Foreign exchange reserves were critically low, and the country's outstanding external debt was very high.

Curiously, Mr. Morrell went on, some of the country's difficulties appeared to follow from an excessively conservative policy relating to the stockpiling and sale of food and export timber. He agreed with the staff that the decision to establish a food stockpile equal to six months' consumption should be reconsidered, particularly in view of the relative stability of food production. He wondered whether a decision to reduce or to hold a smaller stockpile would provide the country with any surplus that could be exported. He noted that an inventory of logs for export valued at some $15-20 million had accumulated as a result of the reluctance of the authorities to sell logs at prices they considered too low. He agreed with the staff that the authorities should make greater efforts to sell the timber, and indeed to expand all exports to the convertible area. Presumably in the matter of timber, the Lao P.D.R. was in the position of being a price taker. He therefore wondered what the outlook was for the prices of the sort of timber that the authorities were trying to export. Looked at differently, he was enquiring whether there was any sound basis for the decision by the authorities to stockpile the timber.

One aspect of the Lao economy he had found fascinating was that its major foreign currency earning export was electricity, Mr. Morrell observed. Many Fund members earned the bulk of their export income from the sale of energy, but very few from the sale of electricity. He had noted that the Lao authorities had recently tripled the price of electricity. He wondered whether the price that they were currently charging was sufficient to cover costs, particularly on a replacement cost basis. He also wondered whether there was scope for a further improvement in prices, something that would presumably depend on the alternatives available to Thailand, which he understood to be the major recipient of the electricity. It would also be interesting to know whether there was any scope for greater use of the electricity within the Lao P.D.R. not only to improve the standard of living but also perhaps to process domestic raw materials for export.

Commenting on the authorities' fiscal policy, Mr. Morrell said that, like the staff, he welcomed their intention to keep the growth of current expenditure to a minimum. They should certainly also implement further measures to improve public savings along the lines suggested by the staff. In addition, they would have to exercise greater restraint over the growth of monetary and credit aggregates if they wished to achieve and sustain a reduction in inflationary pressures. Action should be taken to raise the negative interest rate structure. One encouraging factor was that all the public enterprises were profitable. The authorities were to be commended on that achievement, and he encouraged them to continue with their reforms. Finally, he endorsed the staff's view that the adoption of flexible export prices and a substantial adjustment of the exchange rate were essential for an improvement in the balance of payments and for the future growth of the economy.

Mr. Polak stated that he endorsed the staff appraisal and that he would concentrate his remarks on the question of comparative advantage. In view of the country's endowment with forests, minerals, and hydro-electric potential, it was rather surprising that the per capita income was one of the lowest in the world at about $100 a year. The Lao P.D.R. seemed to be a classical case of the "vicious circle," aggravated by the authorities' policy of achieving and maintaining self-sufficiency in food. At such a low level of income there was little scope for savings or for spending on anything but food, so that little could be left for investment or export.

The shortage of arable land on the one hand and the absence of actual resources on the other probably meant that the country's relative advantage did not lie in agriculture, Mr. Polak commented. Table III in the appendix to SM/84/38 showed that the Lao P.D.R. compared badly with similar Asian countries for yields of all agricultural crops, with the single exception of roots and tubers. And yet over 70 percent of GNP was generated by agriculture. According to the staff, the major objectives of the authorities continued to be the consolidation of self-sufficiency in food, a further rise in the consumption of cereals, and a diversification of agricultural production. To achieve those objectives under the natural constraints of a mountainous and forested country with infertile soil, the Lao P.D.R. would have to make a large investment in soil reclamation, in applying better crop-yielding techniques, in extending the irrigated area, and in raising the level of farming generally. He did not believe, from a reading of the staff papers, that the chances for doing so were particularly good.

In those circumstances, Mr. Polak continued, would it not be more advisable to direct the available resources to the creation of infrastructure--roads, transportation, and electricity--to the development of human and natural resources, and to laying a basis for diversified production and export, combined with imports of foodstuffs? As Mr. Morrell had noted, the Lao P.D.R. was exporting practically nothing at present to the convertible area, except electricity. Simultaneously, artificial constraints on the economy should be lifted. In particular, the pricing system led to distortions. Procurement prices were far from reflecting market prices, and the same applied to administered retail prices. Then, too, the Lao authorities were keeping the price of timber artificially high, leading to an accumulation of inventories. He noted that the authorities had recently relaxed some of their constraints; he would encourage a further movement toward a free market.

The Lao P.D.R. had a high rate of inflation, Mr. Polak noted. The exchange rate--or perhaps rates, because the country seemed to have four exchange rates--should be adjusted accordingly. Beyond that, however, he did not see what could be achieved in present circumstances by the adoption of what the staff called a more active exchange rate policy. Unless the policy of self-sufficiency was replaced by a policy of promoting exports, particularly of natural resources, and of improving the basic infrastructure, no change in relative prices could bring about any meaningful shift in the structure and use of domestic resources.

Mr. Jayawardena remarked that, despite the small population and abundant natural resources, the Lao per capita income was no more than about $128. While there might be some underestimation, the figure was very low for a country with considerable potential. According to the staff, the potential for exporting timber was 40 times present exports and that for generating electricity some 300 times the present production. Naturally, it was important to bear in mind that the Lao economy had only recently emerged from very unsettled conditions.

After recording high growth for the three years up to 1981--admittedly from a very low base--the country had suffered a setback during the past two years, Mr. Jayawardena noted. While adverse weather might have been the main cause, the Lao P.D.R. might be approaching the limits of growth with its present infrastructure. Making any further meaningful progress in developing its considerable potential might depend crucially on the creation of new economic and social infrastructure--transportation, energy, management, marketing, and agricultural extension--and the absorption of new technology. Progress in those areas could not be willed into existence by macroeconomic policies alone. Hence, there was a strong case for the coordination of policies at both macroeconomic and microeconomic levels, and for the mobilization of external resources on concessional terms. The World Bank might have a large role to play in such a situation, and he was glad to learn that discussions were proceeding in the areas he had referred to. He hoped that they would soon be successfully concluded.

As to the macroeconomic policy stance, Mr. Jayawardena observed that he had the impression that the staff, while trying to be objective, found it difficult fully to express the intricate nuances of a centrally planned economy in the jargon of the market economy. For instance, Mr. Ismael had shown in his opening statement how the large budget deficits were only a means of absorbing foreign aid. There must also be some strong reason for maintaining a multiplicity of exchange rates despite the existence of open borders, and for the use of the different notional exchange rates for tax purposes. It would be useful if the rationale for those phenomena could be explained in greater detail.

It was also difficult to understand the large changes in macro variables from one year to another reported by the staff, Mr. Jayawardena stated. Perhaps either the statistics needed further refinement, or economic management in the Lao P.D.R. moved by fits and starts. It was difficult to trace the relationships between fiscal, monetary, and external policies in a traditional sense. All that was evident was that the emerging payments situation and the debt servicing position could prove difficult, and that Lao should aim, first, at increasing production as far as was possible with the existing economic infrastructure, and, second, at mobilizing substantial external resource flows to upgrade the existing economic and social infrastructure.

He welcomed the restoration of incentives in the public enterprise and collective sectors, Mr. Jayawardena remarked. The country could gain from the lessons learned in other centrally planned economies in recent times. As to the emerging debt service, the Lao P.D.R. might wish to consider mobilizing additional, matching domestic resources. No doubt the potential for so doing was limited because of the low incomes of the people. But some saving in budgetary expenditure should be possible, for instance, in the subsidies to civil servants. More liberalization of economic activity, with realistic pricing and incentives, might also turn out to be a source of savings.

Mr. Blandin said that he truly welcomed the 1983 Article IV consultation with the Lao P.D.R. It was always a pleasure to hear about the courageous people of that country. Like Mr. Ismael, he commended the staff for preparing a comprehensive report despite the weakness of the data base and the differences in economic concepts.

He had been interested to learn that agriculture accounted for about 75 percent of GDP, and that it provided the main livelihood for four fifths of the population, Mr. Blandin stated. The country's dependence on foreign aid was noticeable, and he commended the work of the World Bank in the agriculture and energy fields, with five projects already under way and others being studied. Finally, he endorsed the staff appraisal and he could approve the proposed decision.

The staff representative from the Asian Department, replying first to questions by Mr. Morrell, explained that it did not seem likely that the country would be able to export more rice in the future. The Lao P.D.R. produced glutinous rice for which the only foreign market was Thailand, and Thailand was likely to have a surplus at the same time as the Lao P.D.R. The Lao farmers were reluctant to grow other kinds of rice because they would not consume it when there was a surplus. Consequently, the authorities were not counting on significant exports of rice in the future; it was probably for that reason that they proposed to stockpile rice to the extent of six months' consumption.

The timber position was more complicated, the staff representative explained. There were many varieties of timber in the country, and the prices ranged from some \$200 per cubic meter to about \$1,500, to which should be added \$70 per cubic meter of transportation costs to Thailand. The state trading organization had its own grading system, which did not correspond to the international grading system; it had fixed prices that were not at all in line with the world market for lack of expertise. Those with knowledge of the timber exporting business had left the Lao P.D.R., and those who had replaced them had neither the connections in the world market nor the expertise necessary to make the timber export business a success. The authorities were considering accepting technical assistance from Sweden in that field. On a rather weak basis, the staff had assumed that there would be an increase in the world price of timber in the years ahead. However, the major problem was not the world price; it was the prices set by the authorities.

The exports of electricity were profitable, the staff representative stated. When the prices had been tripled in October 1981, there was an additional provision that there should be annual increases of 9 percent a year until 1986.

Responding to Mr. Polak's observations on the nature of comparative advantage in the Lao P.D.R., the staff representative remarked that the soil fertility was not much different from that of Thailand. The yields were rather lower because the pressure to produce was somewhat less in the Lao P.D.R. The country was thinly populated and the economy was largely a subsistence one in which the people usually had enough to eat. While it was true that there were other major resources, such as minerals and hydroelectricity, which could be developed, they took many years of preparation, and the country had no technical skills with which to undertake the work. Some preparatory work had been undertaken in connection with hydroelectric power generation with the cooperation of the Mekong Committee. Nevertheless, the authorities had emphasized the development of the nonagricultural sector of the economy.

A large proportion of investments went toward improving transportation and other infrastructure facilities, the staff representative explained. Very little investment went to the agricultural sector, where the emphasis was on pricing. The aim was to ensure that the farmers received adequate prices and to supply them with sufficient consumer goods to improve their standard of living.

The data base had always been weak in the Lao P.D.R., the staff representative from the Asian Department explained in reply to Mr. Blandin; but the problem had become worse during the past two years because of a major reorganization of the Government. The number of civil servants had been reduced significantly. For instance, in the Ministry of Finance the staff had been cut from 400 to 130, while the staff of the State Trading Company had been completely replaced in 1983, and the new staff was too inexperienced to provide accurate statistics. The staff had discussed the matter with the authorities and had offered to provide technical assistance, particularly in the monetary field and in connection with the balance of payments. The authorities with whom he had spoken were favorable to the idea, but a cabinet decision was required.

Mr. Ismael said that he would convey to his authorities the observations of Executive Directors, which would no doubt be of value to them in formulating their policies.

The Executive Directors would be interested to know, Mr. Ismael continued, that the Government was reorganizing its ministries with a view to achieving greater efficiency in the public service. The process was likely to take some time, but once it was completed the authorities would be in a better position to bring about the necessary economic and administrative reforms. The changes that they envisaged included a reduction in the manpower in government service, a step that was expected to contribute further to public sector savings, which had already reached an impressive level.

As to the nature of the Lao economy, Mr. Ismael commented that official retail prices had been increased by administrative action by 52 percent in 1982 and again by 40 percent in the first three quarters of

1983. In addition, procurement prices for a wide range of agricultural and industrial products had been similarly raised in 1983. It was the administrative price increases that had led to the rise in the demand for money, which had had to be made available to finance the existing level of activity. Furthermore, since in a centrally planned economy like that of the Lao P.D.R., imports were determined by the foreign exchange budget, the impact of monetary policy on the balance of payments could be expected to be fairly insignificant. It was important to recognize that there were major differences between centrally planned and market economies.

The Chairman made the following summing up:

My understanding is that the Directors are in general agreement with the thrust expressed in the appraisal in the staff report for the 1983 Article IV consultation with the Lao People's Democratic Republic. It was noted that, mainly because of bad weather, the Lao economy had remained stagnant in 1982 and 1983; and in the view of Directors, rapid monetary expansion contributed to an acceleration in inflation. As a result of higher current expenditures and a slowing in receipts from public enterprises, the public savings rate had declined in 1983 and, largely because of sluggish exports to the convertible area, the balance of payments registered a deficit for the fourth consecutive year.

Given the limited possibilities for extending the area under cultivation or for applying modern agricultural techniques, Directors welcomed the Government's reliance on more realistic farmgate prices as a means to increase agricultural production. But given the limited potential of the agricultural sector in the Lao People's Democratic Republic and the endowment of the country in natural resources, notably in the hydroelectric and timber fields, the question was asked whether the time had not come for the Lao People's Democratic Republic to shift somewhat from the food self-reliance policy that has characterized the Lao People's Democratic Republic's strategy to a broadening of the productive base of the economy, a strengthening of the infrastructure--notably in the transport field--and an expansion of exports. Public investment, foreign aid, and the World Bank could be instrumental in this redirection of economic policies. Directors also welcomed the greater autonomy granted to public enterprises; it would certainly increase efficiency and profitability.

In view of the heavy dependence on foreign aid and the urgent need to improve the basic infrastructure, domestic resource mobilization should continue to receive high priority. Directors therefore welcomed the intention of the authorities to keep the growth of public expenditures to a minimum, and to enhance the profitability of public enterprises. They observed, however, that other measures to raise public savings, such as adjustment of the customs valuation rate and the extension of recently introduced taxes to public enterprises, should also be given consideration. More stringent criteria for the granting of credit and higher interest rates, in the view of Directors, should contribute to the abatement of inflationary pressures and a more efficient allocation of scarce capital resources.

Directors noted that, with the low level of reserves and the limited scope for foreign borrowing, the balance of payments position was not sustainable. It was felt that the introduction of a more flexible exchange rate policy and the adoption of flexible export prices were essential for an improvement in the balance of payments. In order to avoid shortages of convertible foreign exchange becoming a major constraint on development, measures to strengthen the balance of payments should not be unduly delayed.

The next Article IV consultation with the Lao People's Democratic Republic will be held on the standard 12-month cycle.

The Executive Board then took the following decision:

Decision Concluding 1983 Article XIV Consultation

1. The Fund takes this decision relating to exchange measures of the Lao People's Democratic Republic subject to Article VIII, Sections 2 and 3, and in concluding the 1983 Article XIV consultation with the Lao People's Republic in the light of the 1983 Article IV consultation with the Lao People's Democratic Republic conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes that the Lao exchange system remains restrictive and involves a multiple currency practice described in SM/84/30. The Fund encourages the authorities of the Lao People's Democratic Republic to terminate the multiple currency practice as well as the bilateral payments arrangements with Fund members.

Decision No. 7631-(84/26), adopted
February 17, 1984

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/84/25 (2/15/84) and EBM/84/26 (2/17/84).

3. NICARAGUA - 1983 ARTICLE IV CONSULTATION - POSTPONEMENT

The Executive Board notes the request contained in EBD/84/43 (2/13/84). Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to extend the period for completing the 1983 Article IV consultation with Nicaragua to not later than March 5, 1984.

Decision No. 7632-(84/26), adopted
February 15, 1984

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/84/9, Supplement 1 (2/15/84) and EBAP/84/34 (2/15/84) is approved.

APPROVED: August 6, 1984

JOSEPH W. LANG, JR.
Acting Secretary