NOT FOR PUBLIC USE

0404

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 87/141

10:00 a.m., September 18, 1987

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	A. G. A. Faria, Temporary
	Jiang H.
	M. K. Bush
	D. C. Templeman, Temporary
	G. Seyler, Temporary
	R. Morales, Temporary
M. Finaish	S. K. Fayyad, Temporary
	B. Goos
	D. V. Nhien, Temporary
	L. M. Piantini, Temporary
	M. Foot
	I. Puro, Temporary
M. Massé	
	A. R. Ismael, Temporary
	I. A. Al-Assaf
	V. J. Fernández
	D. Marcel
	V. Rousset, Temporary
	G. P. Hogeweg
	C.-Y. Lim
G. Salehkhou	
	A. Vasudevan, Temporary
	N. Adachi, Temporary
	N. Kyriazidis

L. Van Houtven, Secretary and Counsellor
V. Wall, Assistant

Also Present

IBRD: N. Gorjestani, African Regional Office. African Department: A. D. Ouattara, Counsellor and Director; A. I. Abdi, J. Khallouf, S. N. Kimaro. European Department: M. Russo, Director; P. B. de Fontenay, Deputy Director; M. Guitián, Deputy Director; N. Flores, S. Gupta, L. J. Lipschitz, A. Lopez-Claros, M. A. Pinho, D. C. L. Nellor, H. O. Schmitt, T. M. Ter-Minassian, H. Vittas. Exchange and Trade Relations Department: E. Brau, H. B. Junz, S. Kanesa-Thasan, A. Leipold. IMF Institute: S. El-Khouri, E. Emmanouil, Participant. Legal Department: H. Elizalde. Middle Eastern Department: S. H. Hitti, M. F. Melhem, D. B. Noursi, B. R. H. S. Rajcoomar, C. Sassanpour, B. K. Short, M. Yaqub, M. Zavadjil. Bureau of Statistics: M. Schulze-Ghattas. Advisors to Executive Directors: A. Bertuch-Samuels, G. Pineau. Assistants to Executive Directors: F. E. R. Alfiler, M. Arif, R. Comotto, F. Di Mauro, W. N. Engert, L. Hubloue, S. King, V. K. Malhotra, S. Rebecchini, S. Rouai, G. Schurr, U. Teichmann.

1. COMOROS - 1987 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1987 Article IV consultation with the Comoros (SM/87/215, 8/17/87). They also had before them as a background paper a statistical annex to the staff report (SM/87/218, 8/18/87).

Mr. Mawakani made the following statement:

The economic and financial situation of the Comoros continues to be difficult, despite the measures taken in the past few years, to improve the performance of the economy, especially in the fiscal and real sectors. Economic growth continued in 1986 but at a reduced rate mainly because of a retrenchment in public investment, externally financed. Given the limited natural resources of the Comoros, the authorities' aim is to improve the efficiency of domestic production methods, especially of food and export crops. In the agricultural sector, since producer prices, except for vanilla, are largely market determined, the authorities have been concentrating their efforts mainly on providing extension services to the farmers. Furthermore, it is expected that the strengthening of the banking system could provide the necessary credit to farmers, thus leading to an increase in output. To this end, the authorities intend to seek external assistance with a view to improving the access and the supply of credit to the rural areas.

In the fiscal sector, the overall government deficit, on a payments basis and including grants, fell significantly in 1986 to 10.3 percent of GDP compared to 17.5 percent in 1985. This improvement resulted from higher revenue owing to improved tax collection and enforcement. Total expenditure was also reduced mainly through the curtailment of capital expenditure and the reduction in wages and salaries. Extrabudgetary expenditure was also sharply reduced. Further efforts to improve the budgetary performance are under way. These include the computerization of customs data and the adoption of a uniform accounting system by individual enterprises. The authorities also intend to strenghten control over expenditure, especially over extrabudgetary outlays. In the latter case the aim is to bring all extrabudgetary outlays into the budgetary process. These measures are expected to lead to a further significant reduction in the fiscal deficit as a percentage of GDP, in 1987.

With regard to the public enterprises which are few, about 12, in the Comoros, some of them have registered profits, while others have been sustaining losses. The objective of the authorities is for each enterprise to be financially viable. In order to achieve this objective and correct the weakness in the financial structure of this sector, the authorities in 1986 continued to implement rehabilitating measures. These have consisted in shedding excess labor, in improving the control and management of some of the enterprises, and in an intensification of efforts to collect payments arrears. These measures have met with some success, as they have led to an improvement in financial performance.

The external sector position improved in 1986, owing largely to higher export receipts for vanilla and lower imports. Nevertheless, this sector remains generally weak because of its reliance on only three crops--vanilla, cloves, and perfume essence--for nearly all its export receipts. Indeed, a lack of other natural resources, capital, and technical skills makes it very difficult to diversify the export base of the economy. Therefore, the authorities are directing their efforts to improve the productivity of the export crops sector and the fishing and tourist industries. However, since these efforts will take time to bear fruit, the economy will continue to rely to a very large extent on the foreign assistance of friendly countries for the import of its basic necessities.

With regard to the servicing of the external debt which remains one of the major concerns of the authorities, steps are being taken to improve domestic finances and reduce domestic demand. The authorities have also reviewed their investment and foreign borrowing policies with the view to keeping foreign debt under control. While their efforts to obtain debt relief have not been successful yet, they intend to continue them and to take the necessary measures in the domestic sector to improve the general performance of the economy.

Mr. Rousset said that in the short term, the Comoros was facing an extremely tight financial situation calling for immediate solutions, while the medium and long term held rather poor prospects for growth if present policies were continued. The immediate financial situation was unsustainable, as evidenced by the following numbers: the domestic debt service amounted to 60 percent of budgetary resources; 45 percent of budgetary revenues were collected in the form of cash vouchers, previously issued by the Treasury to pay its suppliers; and the normal servicing of external debt would require about 40 percent of budgetary revenues. Consequently, the Comoros was essentially insolvent, which put at risk the normal functioning of its Government and its whole financial system.

It was crucial that the authorities take decisive action to strengthen revenue collection, particularly by fighting fraud and reducing the number of exemptions, Mr. Rousset continued. While some welcome steps had been taken in 1986-87 to strengthen customs and revenue administration and to exercise better control over budgetary expenditures, the measures had not yielded the expected results.

Hopefully, the designation of a financial controller under the Ministry of Finance would make it possible to exert better control over expenditures, Mr. Rousset went on. Also, the authorities should contain the wage bill by putting a freeze on the hiring of civil servants and by maintaining tighter controls over promotions. The rehabilitation of the public finances required that a solution be designed to settle the domestic arrears and ease the burden of the external debt service. The authorities had made important progress in taking a census of arrears over the previous months. They should now set up a schedule to eliminate cross debt arrears and to consolidate others. His authorities were prepared to continue their technical and financial assistance to the Comorian Government in order to restore the financing needed for the administration to function normally. As for the external debt, there was no alternative for the Comoros other than to enter into negotiations with its creditors in an effort to reach appropriate solutions and to avoid the accumulation of arrears. In such negotiations, the Comoros would present a stronger case by implementing the adjustment policies recommended by the staff.

As for the medium term, the World Bank had recently published a report presenting interesting options to spur development in the Comorian economy, Mr. Rousset commented. Among the items recommended were cash crop diversification, partial substitution of local food crops for imported rice, extensive use of available uncultivated land, and development of a small manufacturing industry for exports. The World Bank document should help the authorities in their reflection on strategy for the medium and long term. Also, an arrangement under the structural adjustment facility would be an appropriate framework for the design and implementation of that strategy; however, nothing would be possible unless the immediate problems had been addressed. The Fund and the World Bank stood ready to assist the Comoros in those tasks.

The 12-month cycle was preferable for the Comoros because of the difficulties in which the authorities found themselves, Mr. Rousset said in closing.

Mr. Al-Assaf made the following statement:

> Let me begin by saying that I support the proposed decision. While progress has been made toward reducing the macroeconomic imbalances in the Comorian economy, the overall performance remains weak. From a short-run perspective, the key clearly lies in restoring fiscal balance. It is important to recognize that some significant progress has been achieved in this area. Notably, the share of total expenditure and net lending in GDP has declined from about 54 percent in 1984 to 35 percent in 1987. However, more needs to be done and the strategy should focus on a combination of tax and expenditure measures. On the tax side, there might be some advantage to broadening the tax base; while on the expenditure side, attention might well be devoted to economies in public sector employment and to bringing extrabudgetary expenditures within the

formal budget process. Given the limited capacity of the authorities to borrow from the banking system, failure to persist with efforts aimed at fiscal adjustment could lead to further increases in arrears. In that respect, I welcome the measures to control extrabudgetary expenditures and to improve tax collection that the authorities intend to implement.

It is important to clarify the situation concerning the official floor price for vanilla as soon as possible. Uncertainty concerning this important producer price can only have a serious negative impact on producer incentives.

The Comorian authorities face no less a task than to establish a new base for economic expansion in the long run. Diversification is essential if the Comoros is to reverse the trend of declining per capita GDP. Here, World Bank involvement would appear to be very important. I understand that the Bank is currently negotiating with the Comorian authorities, and I wonder if we could be updated as to progress in this area. In this connection, I would emphasize that progress in this area would significantly increase the ability of the Comoros to gain access to other sources of concessional financing.

In conclusion, I commend the Comorian authorities for the measures they have adopted to this point. However, they still face a major effort before economic and financial balance will be restored, and before the Comoros's relationships with its creditors are fully normalized. I am encouraged that the authorities are aware of their problems, and I urge them to draw on the expertise of the Fund and the Bank, so as to determine how to move forward.

Mr. Faria made the following statement:

I agree with the proposed decision and generally with the broad thrust of the staff appraisal, but I would like to emphasize some points. Further substantial improvement in the budgetary situation is critical for the Comorian economy. From a medium-term perspective, a sustainable and acceptable rate of per capita growth, together with external viability, can come about only through an appropriate stance of fiscal policy designed to reduce the marked and growing structural resource imbalances caused by the disparity in the rates of growth of output and expenditure. In the short term, the burden on fiscal policy to help bring about the required adjustment is, if anything, greater because of institutional arrangements governing monetary and exchange rate policies. On a more specific note, the dependence of the recurrent budget on external grants, the almost exclusive reliance of extrabudgetary operations on external loans and grants, and the buildup of arrears at the Treasury--all these developments clearly underscore the urgency of attaining a better fiscal balance through fostering a growing level of public savings. While joining Mr. Mawakani in commending the Comorian authorities on the steps taken between 1985 and 1987 to bring down the overall budget deficit and improve budgetary monitoring and control, I would at the same time urge them to persist with, and intensify, these efforts along the lines suggested by the staff.

Against this background, I note with some concern the staff suggestion that fiscal correction in the medium term is likely to be only moderate. Moreover, the staff's medium-term balance of payments forecast concludes that ex ante financing gaps are not likely to be fully covered, even with significant donor support. Inasmuch as action to restore external cost competitiveness can exert only a marginal influence on this potential outcome, I feel that the more important conclusion for the Comorian policymakers to draw from the medium-term scenario is that, even if full donor financing were to become available on present concessional terms, the already onerous debt service burden would increase further by 1991, rather than decrease. Therefore, I would have preferred these debt service implications of prospective financing gaps to be brought out more clearly in the staff appraisal. The prevailing relatively healthy external reserve situation should provide the Comorian authorities with some breathing space with which to address the persisting structural imbalance between the growth in expenditure and output. Accordingly, we fully agree with the staff that the appropriate modality to deal with both the immediate problem of debt relief and the longer-term problem of sustainability of the debt burden is a comprehensive adjustment program that could command wider external bilateral and multilateral support on even more concessional terms.

In concluding, I note that the staff recommends a 12-month cycle, notwithstanding that the authorities, no doubt despite staff explanations, prefer an 18-24 month interval. What should be our position in this regard?

The staff representative from the African Department remarked that the staff had not advocated that the improvement in the budgetary position over the medium term should be moderate. However, considering that a sizable proportion of the current expenditure and, indeed, all capital expenditure was currently financed through foreign grants; that a substantial amount of recurrent and maintenance outlays were currently not being met; that the arrears on external payments and domestic debt were accumulating; and that the fiscal situation was difficult. Accordingly, the staff had not envisaged an improvement in fiscal performance on a scale that would enable the authorities to meet their immediate needs and also to generate substantial budgetary savings. In other words, it was not realistic to think that the medium term would see a tremendous improvement in budgetary savings. Nevertheless, the staff had called for substantial efforts, and it had tried to outline areas in which further progress should be expected.

The staff report contained information on the debt service profile through 1991, the staff representative continued. The impact of new borrowing had not been incorporated into the projections, given that the authorities had not yet defined the adjustment measures or contacted creditors. Needless to say, if one assumed that all the financing gaps would be filled by borrowing on terms similar to the new commitments in 1986, the debt-servicing burden would not change dramatically. In fact, during the final years of the medium-term picture in 1990 and 1991, it would only increase by about 1.5 percent of GDP, because the debt was expected to be incurred on highly concessional terms.

The recent World Bank document on the Comoros called for steps to strengthen the financial position, and it also identified certain areas to strengthen performance on the supply side, the staff representative from the African Department remarked. The authorities had taken note of the Bank's recommendations, and they had indicated a willingness to get involved in serious discussions with the World Bank staff. The authorities had informed the Bank management that they would clarify their intentions on the matter at the Annual Meetings.

The staff representative from the Exchange and Trade Relations Department noted that it was clear that there were doubts concerning the medium-term viability of Comoros's balance of payments position, and even if those doubts were dispelled, there were still grave questions regarding the external situation, particularly the debt service and the maturity structure of the debt. In that situation, the Fund staff preferred to maintain Article IV consultations on an annual basis.

Mr. Mawakani remarked that the Comorian authorities were aware of the difficulties that faced the economy. They had taken measures to reduce domestic imbalances that were expected to lead to further strengthening of the fiscal situation in the coming year. The authorities were also studying the various suggestions made by the staff to further improve the budgetary process and to eliminate arrears.

The Acting Chairman then made the following summing up:

> Directors were in broad agreement with the thrust of the staff appraisal in the consultation report for the Comoros. While welcoming the efforts to improve the fiscal performance in 1986-87, they expressed serious concern about the continued precariousness of the fiscal position. They, therefore, encouraged the authorities to accelerate the implementation of measures to achieve further progress on these fronts, stressing the importance of expenditure restraint and of stronger revenue efforts through

improvements in the administration of domestic taxes and a broadening of the tax base. They welcomed the ongoing initiatives aimed at addressing the problem of overdue domestic obligations at the Treasury and urged the authorities to reduce domestic and external arrears as quickly as possible.

Directors noted that the progress made toward a reduction of the fiscal imbalance had been achieved in a context of weakening economic growth and declining per capita income. The latter, in turn, had necessitated the scaling back of public expenditures to more sustainable levels, with the observed effect on growth. In these circumstances, Directors urged the authorities to pay particular attention to ways of diversifying the economy and bolstering productivity of investment, and, in this context, encouraged the continued assistance of the World Bank in formulating an effective investment program.

Directors observed that, on the basis of present policies, unsustainable balance of payments gaps are likely to prevail over the medium term. Accordingly, they stressed the importance of embarking on a comprehensive program of adjustment, which should primarily be aimed at promoting rapid expansion of food and export crops, accelerating the improvement in public sector finances, and at supporting the authorities' request for continued assistance from the international community. The Comoros should also seek the renegotiation of its very heavy external debt burden.

Directors noted the authorities' preference for the Article IV consultations with the Comoros to take place at intervals of 18-24 months. However, in view of the country's balance of payments and external debt problems, they advised that consultation with the Comoros continue to be kept on a 12-month cycle.

The Executive Board then took the following decision:

1. The Fund takes this decision in concluding the 1987 Article XIV consultation with the Comoros, in the light of the 1987 Article IV consultation with the Comoros conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. The Fund notes that the Comoros continues to maintain an exchange system that is free of restrictions on the making of payments and transfers for current international transactions other than the restrictions on travel allocations which are maintained in accordance with Article XIV, Section 2 as described in SM/87/215.

Decision No. 8698-(87/141), adopted
September 18, 1987

2. GREECE - 1987 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1987 Article IV consultation with Greece (SM/87/185, 7/30/87). They also had before them a background paper on recent economic developments in Greece (SM/87/228, 8/28/87; and Cor. 1, 9/17/87; and Sup. 1, 9/17/87).

Mr. Kyriazidis made the following statement:

The main conclusion of the staff mission's report appears to be that although progress toward adjustment has been made as a result of the stabilization program introduced two years ago, it has been slower and weaker than expected and indeed desired. My authorities are perfectly aware of the weaknesses and shortcomings of developments in the past two years so that they have no difficulty in agreeing with the staff's main conclusion. However, they feel that the results so far achieved have not been inconsiderable and their significance should not be underestimated.

The original targets were, the rapid deceleration of inflation to 16 percent by the end of 1986 and 10 percent by the end of 1987--not including the effect of the introduction of the value-added tax--and the reduction of the current account deficit of the balance of payments from $3.2 billion in 1985 to $1.7 billion in 1986 and $1.25 billion in 1987. These targets have by and large been achieved. Inflation decelerated from an annualized rate of 33.5 percent during the final quarter of 1985 to 16.9 percent by the end of 1986 and, despite some unfavorable developments owing mostly to extraordinary factors--such as the effect of the severe winter, the higher than expected impact of the introduction of the value-added tax, the upward adjustment public utility and administered prices, and the lifting of the price freeze--has further decelerated in the first eight months of this year to a rate that can reasonably be expected to be lower by about 3 percentage points in comparison with 1986.

The current account deficit of the balance of payments has also been reduced from $3.2 billion in 1985 to $1.7 billion in 1986. The staff correctly points out that some significant favorable exogenous factors such as the decline in oil prices and increased transfers from the European Communities contributed substantially to the achievement of the Government's target. However, there were also negative exogenous factors in operation that have not allowed the underlying adjustment trend to manifest itself fully. The extent of this underlying adjustment has, however, become more apparent in 1987 and is reflected in the continuing growth of exports and the vigorous increase in receipts from services and private transfers. As a result, in the first 7 months of the year, as shown in the staff's supplementary paper, the balance of payments deficit on current account has declined from $1.38 billion in the corresponding period of 1986 to $1.1 billion. This combined with a strong recovery of nondebt creating private capital inflows has led to an increase in official foreign exchange reserves by $800 million--an amount equal to the net new foreign borrowing contracted this year. Thus, the achievement of the Government's primary objective--namely, to reduce the current account deficit in the balance of payments from 10 percent of GDP in 1985 to 3 percent, by 7 percentage points, by 1987, appears to be not only attainable but, indeed, probable.

The weak point in the development of the foreign balance is the continuing growth of import demand. This is a cause of concern to the Government as it appears to reflect not only domestic overabsorption, which can be corrected by macroeconomic adjustment or by delayed but reversible J-curve effects, but also increased import penetration owing to liberalization combined with structural weaknesses in domestic supply.

The authorities cannot agree at this time with the staff recommendation that further increases in competitiveness in order to achieve a better performance in the trade balance should be sought by a more rapid slide of the real effective exchange rate because of the risks that such a policy contains of refueling inflationary expectations and encouraging pressures to use exchange rate policy as a substitute for wage moderation and fiscal and monetary restraint. Their intention is therefore to stay on the present course of policy which consists in compensating inflation differentials so as to maintain the degree of competitiveness achieved through the devaluation of 1985.

In the view of the Greek authorities, sustainable gains in competitiveness are to be sought through continued labor cost deceleration in increased productivity, the maintenance of the appropriate monetary fiscal policies, and the encouragement of private investment. In this respect, it is encouraging to note that the incomes policy, the restoration of competitiveness through the exchange rate policy pursued over the last two years, and the extensive liberalization of prices have led to a substantial increase in profitability in the private sector, a radical improvement in business confidence, and a recovery of private investment. According to recent estimates by the National Accounts Service, private investment increased in real terms by 5 percent in 1986 and is expected to rise by 9 percent in 1987. Another indication pointing in the same direction is the results of the latest survey of business intentions by the Industrial Economic Research Institute sponsored by the Confederation of Greek Industries according to which investment in manufacturing by the firms responding to the survey is expected to increase in 1987 by 58.7 percent, as compared with 20 percent in 1986. These figures as well as the recovery of private capital inflow, are sufficiently indicative of the restoration of business confidence and the strong improvement in the investment climate achieved by the stabilization program. These trends are expected to continue in 1988.

The public sector borrowing requirement has also been reduced by 4 percentage points of GDP in 1986 and is expected to be further reduced in 1987. It is in this area, however, that the principal slippages have occurred in 1987, which constitute a major cause of concern for the authorities. The overshooting of expenditures in the social security sector is chiefly responsible for this unsatisfactory development. Corrective measures chiefly on the expenditure side of the government budget were taken last June corresponding to 2 percent of GDP, as described in the staff report, but their results are not as yet apparent in the figures so far available, so that no reliable estimate of the fiscal outcome in 1987 can be presented at this time.

The slippage in the fiscal sector has unavoidably been reflected in the development of the monetary and credit aggregates as presented in the supplementary paper of the staff. It is interesting to note, however, that the shortfall in the expansion of domestic credit to the private sector is not a crowding-out phenomenon but rather the result of a sluggish demand for credit, at least in part attributable to the rise in real interest rates and the enhanced liquidity of the business sector, resulting from the release of advanced import deposits and higher profits.

On the other hand, significant progress has been made toward reducing the structural rigidities of the credit system and adjusting the interest rate structure to prevailing financial conditions. As a result of the measures taken, interest rates on more than half of commercial bank credit are now market determined and the entire interest rate structure on both loans and deposits is positive in real terms as deflation was decelerated.

Some progress has also been made, though unhappily much smaller than hoped for, with regard to the sale of government paper to the nonbank public. From inauspicious beginnings early in the year, the market has developed a clear positive interest which appears to have intensified in the summer following the increase in the yield of treasury bills so that although the targets originally set are not likely to be achieved by a wide margin, it can be safely expected that progress in this field will accelerate in the latter part of the year and especially in 1988. I would like to add that the authorities are very positively inclined to the staff recommendations on this score and are ready to experiment with various forms of paper and marketing techniques in order to expand rapidly the money market and the ability of the public sector to borrow outside the banking system on market determined conditions. Furthermore, the Government has officially endorsed the recommendations of the report of the task force on the reform of the credit system--described in Appendix V of the background paper--and has entrusted the Bank of Greece with its implementation as rapidly as possible.

The Government is determined to pursue the adjustment effort in 1988 and beyond. Their basic strategy would remain fundamentally the same, although in view of the experience of the past few years--which has proved the importance of the relaxation if not elimination of structural rigidities for effective macroeconomic management--it is also determined to give priority to structural reforms.

Macroeconomic targets for 1988 have not yet been quantified. They will be announced with the budget at the end of November. The major guidelines however have already been made clear.

The immediate targets for 1988 are the further deceleration of inflation hopefully to a single digit figure and a further improvement in the balance of payments on current account which will permit at least the stabilization of the external debt. To this effect: incomes policy will be directed toward ensuring continued moderation in wage increases although through a more flexible mechanism than the one applied in the previous two years. Fiscal policy will be directed toward a further significant reduction in the public sector borrowing requirement based not only on stricter expenditure control but also on significant structural reforms in the tax system. Monetary and credit policy will be adjusted to support the achievement of the inflation and balance of payments targets and respond to financial conditions rapidly and effectively both through timely corrective action whenever required and additional structural reforms on the lines of the Task Force report.

On the fiscal front, the official directives on the basis of which the budget for 1988 is being prepared are: the strict containment of current expenditures including a hiring freeze already in place and a revision of the income tax structure aimed at an expansion of the tax base, and a more efficient curbing of evasion. Within this framework and provided that progress toward reducing the fiscal deficit permits, some adjustments of the income tax scale will be envisaged in order to reduce fiscal drag and incentives to the black economy and relieve the pressure for upward real wage adjustments.

With regard to public enterprises, in accordance with the restructuring program that is already being implemented, strict rules will apply as to expenditure through close monitoring of both general expenses and stock control. In addition, medium- and long-term investment expenditures will be approved only on the basis of feasibility studies supported by appropriate cost-benefit analysis, while prices will be determined on the basis of marginal costs with due account to financial charges. Pricing policies however will remain under close monitoring so as to ensure that price adjustments are not used to cover inefficiency.

The major problem in the public sector continues to be the deficits of social security entities. The expenditures of which are notoriously rigid as many countries' experience has shown. It is clear that it is a problem of a structural nature, the solution of which can only be sought in the medium term through fundamental reforms which require careful study and consultation with the social partners. The Government has appointed a Task Force of experts to study the matter. The committee's report is expected in the first few months of 1988. However, these problems are notoriously prone to create serious social and political difficulties and the introduction and implementation of reforms has to proceed with care.

An appropriate incomes policy continues to be a central instrument in the Government's adjustment policies. As indicated in the report, the authorities have felt that the rigidity of the incomes policy applied since October 1985 had to be relaxed after the end of the two-year period stipulated by the legislative decree under which it was introduced. The staff concurred with this view. The specific details of the new policy have not been determined yet. However, the general framework has been announced by the Prime Minister and the Minister of National Economy at the beginning of this month. The main elements are the following: in the public sector salary adjustments will continue to be determined on the basis of the modified indexation mechanism that has been in force in the previous two years. In the public enterprise sector additional adjustments related to productivity will be allowed on condition that they do not serve as a pretext for general salary increases. In the private sector nominal salaries will be allowed to be determined through collective bargaining. The basis will be the modified indexation adjusted in order to permit some flexibility with regard to wage differentials. The system will be operated according to guidelines to be established by the Government after consultation with the social partners and within the framework of the safeguards that are in place, particularly with regard to compulsory arbitration. Productivity bonuses will be allowed after negotiation with the employer at the enterprise level on the basis of results obtained and not in anticipation.

The Government is fully aware of the inevitable uncertainty involved in this process. It is, however, firmly committed to managing the policy in such a way as to prevent wage and salary increases that could undermine the pursuit of deceleration on the inflation front or the maintenance of external competitiveness. The first signal in this direction is the maintenance for the public sector of the strict system applied during the past two years.

Mr. Hogeweg made the following statement:

The better performance of the Greek economy in 1986 relating to inflation and the current account was helped by favorable external circumstances. The improvement evidently could have been even more impressive had the authorities followed more vigorous fiscal and monetary policies. Although, according to the latest available information, the performance thus far in 1987 has been better than was known at the time the staff made its appraisal, I do not think it calls for a different judgment. As Mr. Kyriazidis's opening statement shows, the authorities share the staff's views on the need for tighter fiscal and monetary policies. The medium-term scenarios leave little room for doubt in this regard.

I would like to commend the authorities on the measures already taken and existing plans regarding structural adjustment of the economy--changes in the tax system, deregulations of the capital market, the tackling of labor market rigidities, and decreasing the share of the public sector in the economy, especially in the area of subsidies. These steps are crucial for longer-term success, and possibly even more is needed in some areas.

I believe the staff is right in its concern over public finance and in doubting whether the recent additional retrenchment measures are sufficient. We especially feel that more should be done to raise the prices of certain government services--although this would be inflationary in the short term--and in curtailing subsidies. In this connection, I was intrigued by the reference in the staff report to the "economic rehabilitation of viable ailing enterprises." If viable, why are they ailing, how is viability assessed, and how is the rehabilitation financed? Who bears the cost and the fruits of such a rehabilitation?

The financing of social security evidently is an important impediment to a speedy fall in the fiscal deficit. I appreciate the social and political problems in this area mentioned by Mr. Kyriazidis. Nevertheless, significant steps toward adjustment cannot be avoided. The slippages in the fiscal area clearly reflect themselves in monetary developments. The envisaged reform of the credit system is clearly a large step forward. The creation of a government bond market is indeed necessary both to enable the Government to finance its deficit in a nonmonetary way and in view of the prospect of fully integrated financial markets within the European Communities by 1992. However, as long as the budget deficit is not brought down significantly, no amount of financial reform will be able to compensate for that.

I believe there is substantial room for tightening monetary policy. I welcome the envisaged increases in interest rates on government bonds and the introduction of market-oriented ways to issue this debt. Significantly, positive real interest rates are necessary. Mr. Kyriazidis asserts that the entire interest rate structure is positive in real terms in view of the deceleration of inflation. I wonder if this is really the case when inflationary expectations are taken into account.

When comparing the capital account in the balance of payments of Greece with that of Spain and Portugal, it is interesting to note that in the latter two countries, after they joined the European Communities, inflows of direct investments and portfolio investment approximately doubled from 1985 to 1986. In Greece, after 1980, there has been no such development. Of course, differences in market structures and capital controls are part of the answer. Possibly, however, confidence factors have also been at work. That, of course, would reinforce the necessity for sound policies.

The authorities clearly disagree with the staff on exchange rate policy, and I think they are right. Indeed, a more rapid slide in the real effective exchange rate would fuel inflationary expectations and would encourage pressures to use exchange rate policy as a substitute for wage moderation and fiscal and monetary restraint. I would like the staff to explain why it has insisted on this recommendation against the wishes of the authorities. Of course, exchange rate measures can only have a lasting effect on competitiveness when they are accompanied by adequate domestic measures. But with adequate domestic measures in place, the necessity for exchange rate measures diminishes.

I trust the authorities are well aware that their attitude toward relative exchange rate stability can only be adhered to with adequate fiscal and monetary restraint. That necessity is reinforced by a move toward collective wage bargaining in conformity with the staff's recommendations. I think it is crucial that the Government provides a good example as far as wage formation is concerned.

Mr. Marcel made the following statement:

Our discussion today on this consultation gives us the opportunity to review the effectiveness of the Greek Government's two-year stabilization program, nearly two years after its implementation. In our view, although the program has already borne fruit, the stabilization effort initiated in 1985 must continue, especially in the fiscal and monetary areas.

The macroeconomic objectives of the program were virtually met in 1986, especially the narrowing of the current account deficit to 4.3 percent of GDP--against 10 percent of GDP in 1985--and the falling in the rate of consumer price inflation to 16.9 percent by end-1986, against 25 percent by end-1985. These were highly successful results compared to the earlier poor economic performance of Greece.

This improvement can be linked to the implementation of measures in three main areas: a 15 percent devaluation of the drachma, a restrained fiscal policy, and a substantial modification in the wage indexation mechanism which caused an unprecedented deceleration in the growth of nominal wages. This modification was, without a doubt, the main factor in reducing inflation and improving competitiveness. The reduction in labor costs has been translated into greater profitability for the manufacturing sector, which is important because the key factor underlying the weakening of business investment during the 1980s was a marked decline in profitability, especially in the manufacturing sector. As noted by the staff, this lack of adequate plant and equipment modernization and the consequently aging capital stock would appear to have contributed to the continued concentration of Greek manufacturing output on a low value-added sector. This has exposed the Greek economy to more competition from the newly industrialized centers, with adverse effects on the foreign balance. Even though gross fixed investment continued to fall by 4.7 percent in 1986, profitability and the investment climate has improved. I note with satisfaction that the latest business surveys report a strong rise in investment intentions, as well as a decline in the percentage of firms considering the availability of finance to be a constraint. These recent developments show that the authorities' resolution to fight economic weaknesses has contributed to restoring a healthy climate for business. This climate of confidence is a key element in the success of the stabilization program.

But these efforts must be continued. Recent economic developments in 1987 point to the risk that progress in the areas of inflation or balance of payments would be limited. Indeed, it appears that the target fixed by the authorities will probably not be reached this year. The rate of inflation, projected to be at 13 percent by the Greek authorities, is four times as high as the EC average. On the external side, despite the recent refinancing of external debt, recourse to the international market will have to increase markedly starting in 1988.

The Greek authorities attribute these downturns in part to some special domestic and external factors, but they recognize that slippages in implementing the announced financial policies are partly responsible for the inadequate progress so far in 1987. In fact, it also appears that the economy's response to the stabilization program has been weaker and slower than initially hoped for. Undoubtedly, this comes from a lack of demand control and also from rigidities which hamper the response of domestic supply to demand. I would particularly stress the former. The lower than anticipated decline in domestic demand, despite a strong reduction in real disposable income, was a result of excess liquidity in the economy, partly caused by the financing of the public sector borrowing requirement. Therefore, my authorities consider it necessary to strengthen fiscal and monetary policies. Concerning fiscal policy, a supplementary reduction in public sector borrowing requirements is needed. We note with satisfaction that the Greek authorities have announced fiscal measures to ensure closer adherence to the initial policy target. These efforts must be continued and strengthened, particularly those concerning the deficit of social security entities. In the area of monetary policy, we encourage the authorities to take steps to liberalize interest rates and to contain the creation of liquidity by financing the public sector borrowing requirement.

Lastly, let me just reiterate the importance my authorities attach to implementation by the authorities of policies aimed at improving the supply side of the economy and at strengthening its productive capacity. We encourage the authorities to reduce rigidities and administrative controls; in this regard, we are pleased about the elimination of import deposit requirements which were, in our view, the sole negative aspect of the October 1985 measures.

To conclude, we support the willingness of the authorities in these difficult tasks. The restoration of a climate conducive to business is an encouraging sign, but it is clear that adjustment must be continued beyond the stabilization program.

Mr. Fernândez made the following statement:

The economic performance of the Greek economy has improved significantly in 1986 and in recent months. Substantial progress has been achieved in the areas of inflation and balance of payments, as explained by Mr. Kyriazidis. These encouraging results have been obtained after a stabilization plan was adopted with EC support in late 1985.

We also commend the authorities for their strong stance on wage policy during the last two years, as well as for their commitment to further liberalize prices in the economy. However, the adjustment efforts should continue for the remainder of this year and next year. In this regard, it is somewhat worrisome not to have yet some figures of the fiscal and monetary program and the main macroeconomic targets of the authorities for 1988. However, additional efforts should be devoted to making wages, interest rates, and prices of goods and services more flexible, in order to provide the economy with the right informative signals for the better allocation of resources.

As far as monetary and fiscal policy is concerned, I am essentially in agreement with the staff appraisal. I just want to point out that a further reform of the financial system is required for the authorities to be able to finance the public sector borrowing requirement through orthodox means instead of permanently resorting to bank credit. The authorities should be commended for their efforts to provide the money market with competitive public financial assets, but institutional reforms in the financial system should be speeded up to facilitate the allocation of these new assets among potential buyers. We agree that progress has been made on financial reform, but the 1992 horizon for the EC free capital movement target is very demanding. A lot of work remains to be done in order to move the Greek economy from one that is repressed to one that is flexible.

We associate ourselves with the staff in deeming the introduction of the value-added tax as a welcome step toward modernizing the tax system. However, a further necessary step in this area is to reform the present system of direct taxation with the aim of rationalizing the fiscal structure and increasing in quantitative and relative terms the contribution of this source of fiscal revenues to finance public expenditures. Of course, continuous efforts over the coming years will be required to control public expenditure, to reduce the operating deficits of public enterprises and entities, and to gradually eliminate subsidies. Both revenue increase and expenditure restraint measures can be very unpopular. But we encourage the authorities to maintain, and even strengthen, their efforts to reduce the public sector borrowing requirement.

Recent positive adjustments in real wages should not be offset in the near future by allowing increases in salaries and wages above the productivity level. In this connection, although we would support the elimination of indexation and a movement to free negotiations, we would be concerned about the economic repercussions that the increase in real wages could have on the Greek economy under present circumstances. Unfortunately, we do not see a large margin for wage increases in the near future, especially if there are slippages in the required financial policy implementation.

Although we take note of the recent progress in price policy, price controls should be eliminated as soon as possible. Realistic pricing of goods and services, meaning either realistic free market or cost-related prices, will provide economic agents with the right signals for the allocation of resources. Price controls introduce distortions in the economy and the costs they usually imply are most of the time greater than the expected short-term benefits.

External competitiveness is not just desirable for the Greek economy but an essential requirement given the constraint of the EC commitments. We think that the main component of a policy to restore and maintain competitiveness should be sound macroeconomic policies, without resorting permanently to exchange rate depreciations. Strong financial policies that would maintain inflation and cost differentials in line with those of trading partners should be the basis for the necessary shift in resources from nontradable to tradable goods. At the same time, such predictable and persistent policies will help to stabilize the relative value of the drachma, shutting off speculative movements and uncertainty. Maybe more consideration should be given to the hypothesis of moving from a policy of viewing the exchange rate as an instrument toward a policy of viewing it as a target, although a target that could be adjusted from time to time.

Greek economic growth performance in the near future should be based mainly on investment and exports. We hope that the restoration of confidence in Greek economic policies will be reaffirmed by continuous adjustment efforts. The positive recovery in investment and enterprises' profits, together with a strong export performance after the 1985 stabilization plan, indicate the way that should be followed in order to avoid the temptation of cashing in benefits too soon by relaxing fiscal and monetary policies aimed at promoting economic growth. Unfortunately, it seems that this strategy of internal adjustment to achieve sustainable growth will not find the best external environment in the rather slow economic growth of some of Greece's major trading partners in Europe.

Greece's recent economic performance is very positive. Most of the economic policy measures taken within the framework of the 1985 stabilization plan were in the right direction. However, most of the gradual institutional reforms undertaken since then also represent positive developments to make the Greek economy more flexible and efficient. Further structural and institutional reforms must be implemented without much delay, in order to honor the commitments implied in the agreement for joining the European Communities. A significant reduction in the public sector borrowing requirement and a less accommodating monetary policy will be required to reduce costs and inflation differentials. Finally, strong demand expansion in major Greek trading partners would facilitate the full integration of Greece into the European Communities.

However, the lack of this external support should not justify an inflationary, short-term growth strategy based on internal demand expansion, since strong internal imbalances persist in the Greek economy.

Mr. Goos made the following statement:

I can broadly support the staff appraisal. It clearly shows that substantial and, indeed, commendable progress has been achieved in correcting financial imbalances since 1985, but at the same time, it is clear that the adjustment effort needs to be maintained if not strengthened. The Greek authorities apparently acknowledge this need, which is clearly borne out by the likelihood that in several areas even the revised official forecasts for 1987 might be missed and also by the prospect of reversal of the previous year's improvement in the trade account. In this regard, I should perhaps add the concern expressed by Mr. Hogeweg when he referred to the disappointing development of foreign direct investment, at least compared to other countries in a similar situation.

Against this background, maintenance of external competitiveness will remain critical to growth performance and external viability. This will certainly require continued attention to the appropriateness of the exchange rate. But exchange rate policy cannot compensate for firm financial, incomes, and structural policies--particularly not given the external circumstances of the Greek economy. In any event, the staff's well-considered advice to moderate price and cost pressures through the promotion of domestic and external competition would be difficult to achieve with the pursuit of an accommodating exchange rate policy. Such a policy could also give the wrong signal in respect to the authorities' willingness or ability to persevere in their effort to reduce the existing domestic imbalances.

In this context, the fiscal deficit remains a matter for serious concern both with respect to the repeated overruns in the official targets and its actual size. The likely outcome for the public sector borrowing requirement this year is clearly unsustainable in view of the pressure it imposes on domestic resources and the external accounts. There is an urgent need for decisive action to improve the situation, and the efforts should indeed focus on the reduction of subsidies, including the reform of the social security system--though I acknowledge, of course, the difficulties involved in such reform, as mentioned by Mr. Kyriazidis. Such efforts should be supplemented by measures aimed at reversing the declining trend in private household savings, a trend which I found quite worrisome and, at the same time, difficult to understand, at least in terms of its extent in the past three years.

Maybe the staff or Mr. Kyriazidis could shed some light on this issue and offer some comments on how the situation could be remedied.

I also endorse the staff's recommendations regarding the reform of the financial system. The recent liberalization and adjustments in interest rates is certainly most welcome, but the authorities still have to go a considerable distance in adapting their financial system to the conditions prevailing in the European Communities. In view of the often-cited forthcoming full integration of Greece in the EC's financial market, I wonder whether the authorities should not envisage adopting the obligations of Article VIII. In the same vein, I also encourage them to bring Greece's SDR holdings to more appropriate levels.

Mr. Foot made the following statement:

It is certainly a more encouraging picture before the Board this year than in the previous Article IV consultation with Greece. The Greek authorities have made considerable progress toward achieving the goals of the adjustment program announced toward the end of 1985; but obviously there is also a good deal more to be done, as the authorities themselves recognize. For example, the staff correctly emphasizes the importance of demand-management policies in strengthening the external position and achieving a sustainable reduction in inflation.

Important measures have been put in place on the fiscal front, but there have apparently been some slippages. While it is encouraging to see that the authorities have taken additional measures to reduce planned spending, it is doubtful whether these will be sufficient to achieve their objectives. This is somewhat worrying as further fiscal overruns could damage the authorities' resolve and could put further upward pressure on inflation and the external position. I hope, therefore, that the authorities will be ready to take further measures to strengthen the fiscal position in the relatively short term, and I would urge them to give considerable thought to the merits of medium-term planning and public announcement of medium-term objectives in the years ahead, which could help to mobilize public opinion by showing the way ahead. For example, until the budget is available in November, no one has very much idea of the authorities' targets for 1988, let alone further ahead.

In recent years, monetary policy appears to have largely accommodated pressures stemming from the fiscal side. Real interest rates have been persistently negative, at least until recently. The relatively loose policy stance may well explain some of the pressures on inflation. The authorities' recent decision to increase some interest rates and to reduce some of the distortions within the financial system was thus appropriate. I would agree with those speakers who have noted that the financial system continues to be heavily regulated and that further steps to increase the flexibility not only of interest rates but of the financial system in general would be desirable. The staff report makes clear that demand-management policies will need to be accompanied by further structural measures.

A recent EC survey concluded that Greece was the country in the European Communities where reducing labor market rigidities would have the greatest impact on employment in manufacturing. I hope the authorities will redouble their efforts in this area. In addition to further steps to reduce direct administrative controls on labor market decisions, greater wage flexibility will also be appropriate. One of the impacts of the incomes policies followed over recent years has been a sharp compression in earnings differentials. I was glad to see, therefore, that the authorities recognize the need to allow a widening of differentials when circumstances permit.

Turning to conditions in the goods markets, I was again struck by the role structural measures could play in generating stronger growth prospects. At present, a significant number of enterprises are apparently in weakened financial circumstances, and the authorities are taking steps to restructure some, and to sell off all of those that cannot be made viable. However, the authorities continue to provide various subsidies to the corporate sector. Those distortions should be avoided by providing any essential financial support in explicitly budgeted subsidies. In that connection, although the scope of price controls has been reduced, informal agreements continue to be reached with a significant number of firms concerning prices. Allowing freer determination of prices would undoubtedly promote greater competitiveness and flexibility within the industrial sector.

Greater freedom is also the appropriate theme for the external trade and payments system. I welcome what has been achieved in the previous year, but the details of the background paper, and Mr. Goos's recent remarks, reminded me just how large still is the gap between the least, and the most, restrictive countries of the European Communities, particularly as far as Greece is concerned in respect of capital movements.

My own feeling about the exchange rate is that if the authorities can achieve their current account aims for this year and next with the present exchange rate policy, well and good, and the prospects for this, given the latest data, must be better than before. But if not--and here clearly the importance of acting early is critical--I would urge them to reconsider if the subsequent data demonstrate the need to do so.

Mr. Al-Assaf made the following statement:

For the past two years, Greece has been implementing a stabilization program with a view to reducing both domestic and external imbalances. In some respects, this program has been successful. Indeed, the supplement to the background paper indicates that the current account deficit in 1987 will be significantly reduced. Further, even though inflation will exceed its original target, it will nonetheless be substantially below the rates of the recent past. In addition, exchange rate policy is being managed flexibly, and with the reduction in real wages, profitability has been restored somewhat.

I commend the authorities for their success. However, it must also be recognized that some slippages have occurred. The public sector borrowing requirement for 1987 is going to be both higher than expected and larger in absolute terms. Deficits of this magnitude, in addition to upsetting the balance of aggregate demand, will also compromise the independence of monetary policy, especially so in the case of Greece, where the absence of well-developed capital markets has resulted in significant portions of the deficit being monetized. However, on this point, I wish to commend the authorities for the manner in which they have recently liberalized interest rates. This is an important step which will widen capital markets, reducing the financing pressures on the monetary authorities. I would encourage the authorities to reinforce these measures by additional improvements in the financial system.

More generally, the authorities are clearly aware of what needs to be done now. I find their recent efforts to tighten fiscal policy most encouraging. I would only emphasize the need to persevere with these efforts over the coming years, and here I have a few brief comments concerning what might be the appropriate strategy in that regard.

Further tax reform should receive high priority. For example, I understand that the income tax, with a top marginal tax rate of 63 percent, is both high and progressive, and yet the revenue yield has been very low, and surprisingly inelastic. Further, there is much evidence of tax arrears. I believe we have here an example of how tax rates can be reduced, while at the same time tax revenue can be increased. In this connection, I welcome the authorities' intention to reduce top marginal tax rates.

There has been a sharp increase in social security contributions. I would encourage the authorities to address this problem and, in particular, would hope that future social security benefit increases are constrained as much as possible.

The European Communities has singled out Greece as the country that would benefit most from a reduction in labor market rigidities. Reducing those rigidities offers the best hope for increasing potential output. In this connection, I welcome the proposal to remove the indexation mechanism in the private sector, although developments in this area should be monitored carefully so as to protect against a wage explosion.

Greece has achieved much, but more remains to be done. However, in light of their expressed determination to tackle the remaining problems, I am confident that the authorities are in the process of placing the economy on a sound basis, from which it can return to a path of sustained growth. I support the proposed decision.

Mr. Vasudevan made the following statement:

In general, I find myself somewhat uncomfortable when so many variables are placed under targets or forecasts. It is not a question of semantics, because one cannot have a multiplicity of targets for a short period without extremely well-designed, well-tested sets of policy instruments. Such a situation requires one to have a dependable knowledge of transmission channels and the time it takes for the transmission effects to fully work themselves out. I am afraid, quite often, the desirable ideas that one has of the movements in variables enter the picture as "targets." In reality, however, there are perhaps only one or two objectives, the targets for which are often laid down, and the rest are variables, the numbers for which are derived out of an internal consistency exercise. But how far these numbers are feasible, as against desirable, it is not easily known, unless one has knowledge about the transmission mechanisms. We would, therefore, think that if certain numbers are not ultimately reached within a period of one year, it does not necessarily imply that there is a slippage in policymaking or implementation.

We found a number of favorable developments in the Greek economy in 1986, which need to be highlighted with a bit of historical context attached to them.

The growth rate in real private consumption was much lower in 1986 than in any one year since 1981. As Mr. Kyriazidis has pointed out, the growth rate in private fixed investment in real terms was also higher in 1986 than in any one year since 1981. He provided an additional argument in favor of the rise in private investment in terms of the survey results of business intentions that indicate that the 1986 outcome has given rise to business confidence. Following from this point, the rate at which real gross fixed investment in the manufacturing sector was higher than in any one year since 1981.

It is important to note that for the first time since 1981, real public fixed investment showed a decline, which is indicative of the probable or possible shifts in the roles of the public and private sectors. Real export growth generally declined every year since 1981 with the sole exception of 1984.

The staff points to the large rise in real imports in a vain that appears to place it as an unfavorable development. Mr. Kyriazidis, too, regarded this as a cause of concern. But at 3.6 percent according to national accounts data, the increase in 1986 was lower than or equal to the expansion rates in any one of the past five years, with the single exception of 1984.

The rise in unit labor costs in 1986 was lower than the rates recorded in any single year since 1981. Real earnings on average declined, by a large proportion, compared to the trends in the previous five years. In most past years, there was, in fact, a rise in unit labor costs.

Net public sector borrowing requirement as a percent of GDP declined sharply by about 4 percentage points in 1986--such an order of decline was not seen in any of the earlier four years--and is in fact projected to decline further by about 2.5 percentage points in 1987. The order of decline compares favorably with the trends seen in most other countries of the industrial world.

We pointed out these favorable developments, because in our view, they indicate a shift from past trends which apparently is desirable. We also would like to reiterate what several other Directors have pointed out, that the main objectives of the program--the declines in the inflation rate and external current account deficits--have been fulfilled in 1986 and are likely to be fulfilled in 1987 as well.

However, we recognized, like the staff, that in the coming months and in 1988, the adjustment strategy needs to be pursued with vigor toward the fundamentally same objectives, with some priorities provided for structural reforms. We find Mr. Kyriazidis's description of the various elements of policy for 1988 in line with, and strengthening, the adjustment effort of the past two years. We feel that the staff's suggestion for a more rapid decline in the real effective exchange rate in order to improve competitiveness is unconvincing. Such a policy is likely to fuel--perhaps refuel--inflationary expectations, which going by the latest price trends, seem to be somewhat subdued. We can agree with the view of the authorities that labor cost deceleration, and an appropriate monetary-fiscal policy mix, are important factors that provide sustainable gains in competitiveness. And it is here we found the broad contours of the incomes policy interesting and realistic. In the monetary-fiscal policy areas, we will watch, with interest, the financial market developments and innovations and the manner in which the deficits of social security entities would be tackled. It is going to be a heroic task to tackle the structural rigidities in the social security entities' expenditures, considering the serious sociopolitical implications that such actions carry.

Mr. Puro made the following statement:

I welcome the significant improvement in the performance of the Greek economy in 1986, which has resulted both from adjustment measures and from favorable external developments. The authorities' commitment to adjustment policies is highly commendable and is no doubt crucial for future economic progress.

Economic progress in 1987 has, however, not continued at the pace expected. Notably, price and balance of payments developments have lagged behind expectations. This is the more worrisome as the unsatisfactory performance appears to be a reflection of weak progress and slippages in policies. In particular, the tightening of financial policies seems to have been inadequate.

The authorities have responded to the overrun of the public sector borrowing requirement through the announcement of certain corrective steps. Nevertheless, when considering the measures, such as stricter enforcement of the public sector hiring freeze and stepped-up attempts to collect tax arrears, one may raise doubts as to whether they are sufficient to correct the situation. In addition, they do not seem to be directed toward a permanent improvement in public finances. More fundamental reforms, particularly in the tax system and in subsidies and public enterprises, are called for. The length of time until the next elections has an important bearing on the urgency of these reforms.

The authorities have recently taken action to tighten liquidity. In particular, the intention seems to be to affect private sector financing. I hope there is no risk that developments, in a situation of strengthened business confidence and increased investment intentions, could lead to a crowding out of the productive investments needed to enhance production capacity.

I welcome the continuation of the liberalization process in financial markets. Many of the structural rigidities have been removed, and a good part of the interest rates are now market determined. However, much still needs to be done. Liberalization should be gradually converted into a profound reform of the financial system. The final target has to be a highly deregulated financial system where distortions have been dismantled and market mechanisms play a central role. The report of the task force should be a precursor to the adoption of a timetable for the reform.

I note with satisfaction the recent trade liberalization measures and, in particular, the elimination of the import deposit scheme. I have some understanding for the staff's point in cautiously recommending an acceleration of the pace of effective depreciation of the drachma over the next few months. However, there may also be risks attached to this, unless a simultaneous strengthening of measures on the internal side takes place. It is obvious, that to maintain competitiveness, the authorities cannot in the long run count on accommodating exchange rate policies. The sooner action is geared toward a firmer financial and incomes policy stance, the better the future outlook for competitiveness.

I want to make a general comment on the staff documents for Article IV consultations. Having in front of me the staff report on Greece, with its 31 pages, and the background paper with 175 pages, I would very much urge the staff to strengthen their efforts to shorten the documentation in line with the understanding stemming from the discussions on consultation cycles early this summer.

Mr. Lim made the following statement:

We are happy to note that the stabilization effort initiated in late 1985 has begun to show some good results. However, a good part of this progress was contributed by the better than anticipated external environment which appeared to have afforded the authorities some room for relaxation.

We note also that unless further measures for financial tightening are implemented, 1987 targets for inflation and external accounts appear to be unachievable. We see these as definite signs of excess demand in the economy--the relatively low investment to GDP ratio indicates that demand is being driven by high consumption--and the persistence of a high net borrowing requirement of the public sector and the continuing rapid increase in monetary and credit aggregates as signs of an accommodating stance of policy. Slippages in the early part of 1987 may be compounded by higher expenditures not heretofore budgeted and additional revenue shortfalls, the expansionary impact of which may not be fully mopped up by additional sales of treasury paper.

We therefore fully support the recent corrective measures implemented by the authorities, particularly the further cutback in outlays for lower priority public investment projects, a stricter enforcement of the hiring freeze in the public sector, and the improvement in tax collection. At the same time, we also see merit in the staff's proposal to increase public sector charges and to cut subsidies.

While we welcome the recent moves to liberalize certain interest rate regulations, particularly the lifting of the ceiling on loan rates, we fully agree with the staff that the new rates on treasury bills should be market tested and that the authorities should be prepared to accommodate the market-determined rate.

While we support the authorities' views that the pursuit of firm financial and fiscal policies is essential in addressing the emergence of cost and price instability, at the same time the near doubling in external debt in the five years 1982-86 and the substantial increase of its ratio to GDP indicate that a more flexible policy stance for the exchange rate policy may be equally necessary, especially to achieve the higher levels of exports crucial to sustained growth.

Finally, we can support the proposed decision.

Mr. Seyler made the following statement:

The report before us shows how difficult it is for a small, open economy to follow an adjustment path. Nonetheless, the trend revealed by the various tables shows that the Government's efforts are producing results and that the economy is on the right track toward recovery. The unemployment rate is relatively low by comparison with other EC countries, and both the government deficit and the current account have subsided markedly from their 1985 peaks.

Given that these imbalances are still rather high in absolute terms, we should also keep in mind the common wisdom that adjustment efforts require time to bear fruit. A more worrisome point to me is that the growth rate for the last few years has lagged considerably behind the relatively high rates of the 1970s. However, if the underground economy were to be counted, as in the case of Italy, the picture might be quite different.

Allowance must also be made for changes in the economic climate and the recent sluggishness of the world economy, which lie beyond the authorities' control. Even so, we agree that further effort should be directed to removing the many weaknesses and rigidities on the supply side that impede output response to a situation of relatively low labor costs.

I agree with Mr. Kyriazidis that perhaps the staff insists too much on the advantage the Greek economy has taken of a favorable external environment, because any benefit seems to have been largely canceled by adverse factors--a decrease in tourism from the United States owing to dollar depreciation and terrorism, more general losses in tourism after the Chernobyl accident, the impact on the whole economy of prolonged bad weather, and the slowdown of external demand.

The staff report discusses the indexation mechanism of the Greek economy in detail. As we have said on previous occasions, we believe that indexation can have beneficial effects. It helps eliminate protracted negotiations with the unions and promotes social tranquility by preserving the purchasing power of the lower income classes. This is even more important when inflation is high. However, indexation needs to incorporate some flexibility or safeguard clauses, as it does in my country. For instance, indexation should be limited by certain ceilings to leave some room for wage negotiations by companies. This will promote a degree of wage differentiation within companies and thereby provide incentives to work hard. In addition, wage differentiation between sectors promotes labor mobility. Mr. Kyriazidis indicates that such measures are being planned.

Concerning the follow-up measures to be taken by the authorities, we agree that the emphasis should be shifted from wage policy toward financial policy. A special effort should be made to reduce tax fraud and to tax the underground economy. Additional hirings by the tax administration could prove to be an investment with a high marginal return.

To ensure nonmonetary financing of the budget deficit, capital markets must be developed. An efficient capital market has enabled Belgium, for instance, to finance its budget deficits in an orderly way, while removing excessive liquidity and improving savings rates. Higher savings rates in Greece would also help prevent an import surge following reduction of the regulatory tax and the elimination of import deposits.

Tax incentives could be an important tool for promoting capital markets. For this tool to be effective, however, the authorities will have to lower the expectation for inflation considerably and reduce interest rates to a level unlikely to trigger snowballing of the Government's debt. The authorities must therefore take clear positions in their public announcements and adhere as closely as possible to the policy targets they initially announce. We are convinced that the discipline imposed by the EC membership will further encourage the authorities to bring their general financial balance and monetary expansion into closer alignment with the other EC members, which will also help lower the high interest rates.

Ms. Bush made the following statement:

We welcome the progress that has been made by the Greek authorities in addressing economic and financial imbalances. There has been significant improvement in 1986, as evidenced by the turnaround of the current account and the progress made on inflation. We also note the improvements in profitability in the private sector, the recovery of private sector investment, and at least the beginnings of a recovery of some nondebt-creating, private capital inflows. These latter developments point up the benefits to be derived from adjustment efforts. As the authorities have pointed out, there are continuing weaknesses in the economy, and we encourage the authorities to address them. In that regard, we note the authorities' view that further adjustment in 1988 and beyond will be required, as the 13 percent rate of inflation is still high in comparison with that in other EC countries, and as Greece will require financing from the international financial markets in 1988 and beyond in the face of already high debt service requirements.

We welcome the objective of stabilizing the current account deficit at a level that can eventually be covered through nondebt capital flows. However, we do concur with the staff that to attain this goal the authorities will need to continue along the road of adjustment, placing particular emphasis on the fiscal area and on steps to improve the supply response and the climate for direct foreign investment and domestic savings. The further development of the capital markets will be important to improving the supply response. Mr. Kyriazidis's opening statement noted the authorities' receptiveness to exploring various forms of financial instruments and marketing techniques that can help with the sale of government securities to the nonbank public, which, coupled with more general reform of the capital markets, can be helpful in the implementation of disinflationary monetary policy and in developing domestic funding sources for private investment and expansion. In other words, reform of the capital markets is certainly very important to correcting structural problems and to encouraging the supply response of the economy. We do, of course, have a number of concerns about the problems that remain and some questions that we would like to raise in some specific areas.

The Greek authorities themselves have noted that the public sector borrowing requirement needs to be controlled. I noted in Mr. Kyriazidis's statement that stricter expenditure control will help achieve this aim. He points specifically to monitoring expenditures and stock control in the public enterprises; to the cost/benefit analysis that will be caried out when making investment expenditures; and to some steps that have been taken or are being looked at to address expenditures with regard to social security and the task force study. In addition, the staff report mentions stricter enforcement of the hiring freeze in the public sector.

These are certainly very welcome steps. However, in order to bring about more lasting improvement in the public sector finances, other areas need to be tackled, such as subsidies and the prices of some petroleum products. Even in noting the intended constraints on public enterprises, I understand that the excess manpower in public enterprises ranges somewhere between 5 percent and 45 percent. This would tend to further support the need for enforcement of the hiring freeze. One question that I would like to raise in relation to the staffing of the enterprises is whether or not any kind of an estimate could be given of the impact on the budget of the overmanning in the public enterprises. Also, I understand that the average gross monthly earnings of the public enterprise employees are higher than in many other sectors of the economy. Is this differential between public employees and employees in other sectors of the economy expected to persist?

With the exception of the Public Power Corporation, the public enterprises have held price increases below the rate of inflation, which has resulted in the need for public enterprises to rely fairly heavily on borrowing. I wonder whether price increases will be allowed so that the indebtedness problem of the public enterprises can be eased. Also, what is the prospect in the foreseeable future of placing the public pension system on a self-financing basis?

Real interest rates on deposits and loans are to be restored to positive levels, and I would be interested to know when this first phase of the reform will be fully implemented. Also, has a timetable been established for the next phase of the reform?

I note the modifications in the incomes policy and the tax reform that is intended to reduce tax rates and the resulting fiscal drag caused by high tax rates. Tax reform measures in the direction that the authorities appear to be going can be very important to bringing economic activity back into the formal market. The staff notes that the black market has escaped the incomes policy; I think movement of black market activity to the formal economy would be encouraged by lesser reliance on incomes policy.

I endorse the staff view that flexibility in wage determination and heightened wage differentials to reflect productivity are important structural measures that are needed to begin correcting labor market rigidities.

A freer, more competitive environment with regard to labor, capital, and the goods market are all very important areas for the Greek authorities to tackle. I believe that progress in these areas would help with continued achievement of their goals for a more sound and growing economy that would enjoy greater confidence, both domestically and with the international community.

Mr. Salehkhou made the following statement:

The stabilization program that the Greek authorities have undertaken since 1985 has begun to produce a favorable impact on the economy. Improvements were achieved in 1986 in containing the rate of growth of the consumer price index and in reducing both the current account deficit and the public sector borrowing requirement. The authorities are to be commended for tackling structural rigidities and attaining satisfactory performances. In this connection, I tend to agree with Mr. Kyriazidis than perhaps the staff, in its assessment of economic achievements, has given more weight to the favorable external environment than deserved, given the extent of adverse external developments affecting the performance of the economy. However, strengthened efforts will be required in 1987 and beyond to consolidate the gains already achieved and further lower the imbalances in the Greek economy. Such efforts could be reinforced in the following areas: containing the public sector borrowing requirement, introducing more flexibility into the financial markets, and reducing the size of the underground economy.

Reducing the public sector borrowing requirement, which was the cornerstone of the stabilization program, was regarded as a necessary precondition to lower the growth of the monetary aggregates, to bring down the inflation rate, and to stabilize the foreign debt. Although the public sector borrowing requirement in relation to GDP was reduced from its peak of 17.5 percent in 1985 to 13.9 percent in 1986, the objective of 7 percent reduction was not achieved. The authorities' efforts to stabilize foreign debt was fairly successful, but led, however, to further domestic financing of the public sector borrowing requirement, especially from commercial banks. Therefore, the growth of total domestic credit exceeded the program target by 3 percentage points.

The authorities are well aware of the need for further tightening of financial policies. The measures announced to reduce public investment and to improve collection of tax arrears are steps in the right direction. These measures could also be consolidated by the reduction of subsidies, which the staff considers pervasive, and grants that represent 7.7 percent of GDP, the second largest item of government expenditures. Fundamental reforms should also be introduced in the public sector to contain the deficit and in the social security system. In this connection, however, we agree with Mr. Kyriazidis that such courageous reform measures have to be implemented with caution so as to minimize their social impact.

The introduction of the value-added tax and of a new tax information code constitute important steps toward the modernization of the tax system and could assist in raising revenues by minimizing tax evasion. In this regard, special emphasis should be placed on reducing the size of the underground economy estimated to be 28.6 percent of GDP and 27.6 percent of declared income. As indicated by the staff "the skewed distribution of the income tax burden has supported the incentive for wage earners to resort to underground activities in order to supplement their income." The authorities' intention to reform the direct income tax system is appropriate and should be encouraged.

Management of monetary policy is hindered by the level of the public sector borrowing requirement and by the imposition of a high level of secondary reserve requirements, which, together with a highly state-controlled banking system that is characterized by a fairly complex set of regulations and controls, resulted in excessive reliance on the banking system and a relatively underdeveloped capital market.

Recognizing the need to liberalize and deregulate the banking system, the authorities have come up with a comprehensive reform package in order to modernize this sector in view of the planned integration of the internal markets within the European Communities by 1992. In that final phase, this reform would lead to the abolition of the earmarking of bank deposits and the Bank of Greece would be in a position to control money and credit aggregates through regular central banking instruments. Some initial measures were introduced in 1987 to promote competition among banks and to reduce the overall proportion of commercial bank deposits on reserves. This comprehensive reform would help modernize financial institutions and markets and will facilitate the recourse of the public sector to nonbank borrowings on market-determined conditions. In this regard, I welcome the authorities' intention to step up the pace and implementation of the reform package in advance of the adjustment program target. However, this should be accompanied by strengthening the monitoring and supervising role of the Bank of Greece so as to ensure a smooth transition from a highly regulated banking system to a market-oriented one and to prevent any negative impact on depositors, borrowers, and the banking system. Moreover, the pervasiveness of state influence should gradually be eliminated so as to enhance competitiveness and to improve the efficiency of the banking system.

While much has been done by the Greek authorities, the medium-term scenarios highlight the need for continuation of the adjustment process beyond 1987, to improve competitiveness of the economy and to reduce the remaining structural rigidities. These scenarios suggest, however, that the debt service ratio and the gross borrowing requirements are likely to remain on the high side, which reinforces the fact that adjustment efforts should be supported by sufficient financing if they are to be effective and growth oriented.

Mr. Fayyad made the following statement:

The performance of the Greek economy has improved considerably under the 1986/87 stabilization program aimed chiefly at reducing inflation and improving the external position. Despite some transitory influences on the price level and a slowdown of demand in some major trading partners, the program targets in these two important areas have been largely met. Notwithstanding some slippages, the determination shown by the authorities in the implementation of the policy measures under the program should boost confidence in the outlook of the Greek economy, domestically and abroad. Indeed, the recent increases in real investment and recovery in private capital inflows that are highlighted in Mr. Kyriazidis's opening statement are strongly indicative of the rise in confidence in the Greek economy that has been achieved by the stabilization program. To maintain the momentum already achieved, the authorities should continue to move resolutely toward realizing the ambitious objectives they have set for themselves.

The reduction in the public sector borrowing requirement in 1986 is a welcome development. However, the expected overrun in the public sector borrowing requirement, largely attributable to overshooting in the social security system, is a source of concern. We, therefore, feel that the corrective measures on the expenditure side that have been taken recently are appropriate. We are also encouraged by the high priority the authorities continue to attach to this matter in their policy strategy, and specifically by their intention to achieve a reduction in the public sector borrowing requirement based not only on stricter expenditure control but also on significant structural reforms in the tax system.

The recent measures to liberalize some interest rates and raise others and to tighten liquidity in the banking system are steps in the right direction. We are also encouraged by the authorities' favorable disposition toward the staff's recommendations on the need to increase the sales of treasury paper to the nonbank public.

The exchange rate policy pursued over the past two years appears to be generally appropriate since it has been guided by the principle of not allowing the effective devaluation of the drachma to be eroded with price movements. We have noted the staff's view that some acceleration of the pace of effective depreciation of the drachma over the next few months would help compensate for the impact of the recent trade liberalization measures on competitiveness. However, on balance, Mr. Kyriazidis's arguments against this view are convincing. We especially agree with him that a more rapid pace of effective depreciation would tend to mask the need for enhancing competitiveness through further wage moderation and fiscal and monetary restraint.

The staff representative from the European Department said that the staff was in agreement with the authorities that external factors had accounted for more than 60 percent of the improvement in the balance of payments. Only 2 percentage points out of 5.7 percentage points of GDP represented improvement that the authorities attributed directly to the effect of the stabilization program. Although those calculations were subject to uncertainties, the staff had not questioned them.

The staff had not recommended a real depreciation of the exchange rate but rather an acceleration of the pace of the effective slide of the exchange rate to compensate for the elimination of the import deposit requirement and the export subsidies, the staff representative continued. The authorities were using an exchange rate based on relative unit labor costs, which did not take into consideration the impact of the elimination of the import deposit requirement and the export subsidies on the relative prices of traded and nontraded goods. The staff was not advocating that exchange rate policy should be the primary instrument for achieving competitiveness but that it should compensate for remaining differentials in relative costs and prices following the implementation of disinflationary financial and other economic policies. Therefore, there was not actually a disagreement between the staff and the authorities on the issue of the exchange rate policy.

There were a number of explanations for the decline in household savings in 1986, the staff representative went on. Uncertainties as to the authorities' strength of commitment to the program might have played a role. Also, the cut in real wages during the stabilization period had been sharp--unprecedented in recent years. Thus, it was possible that households might have reacted initially by reducing savings rather than curtailing consumption. In any case, consumption had been facilitated by ample liquidity in the economy, since clearly there had to have been a drawdown of financial assets and time deposits to finance the relatively high level of spending, given the cut in disposable income. Also, owing to the strength of the underground economy, the cut in disposable income might have been less than indicated in the figures in the staff report or from the estimates provided by the authorities.

Interest rates were not much in excess of the existing rate of inflation, the staff representative noted. It was even possible to argue that they were below the ex post rate of inflation, which included the price boost at the beginning of the year from the value-added tax. Regardless, the level of real interest rates was not adequate. Given that a portion of the financial market remained controlled, there was not enough of a market test to determine exactly what the rate should be. The staff's recommendation had been to move as quickly as possible toward full liberalization of the interest rates. In that light, the staff's suggestion to establish auctions for treasury bills had been relatively well received by the authorities, and perhaps in the near future action would be taken in that direction.

The authorities were aware of the shortcomings of the existing social security legislation and practices, the staff representative commented. They ranged from a too low retirement age to the possibility of accumulation of pensions to the shortness of the period of reference on which the pension was calculated. Clearly, there was scope for adjustment in that area if the political will existed. Social security reforms were especially sensitive politically, and the authorities would need to prepare the ground through dialogue with the social partners.

As the estimate of the degree of overmanning in public enterprises ranged from 5 percent to 45 percent, it was impossible to pinpoint the cost to the budget represented by overmanning, the staff representative continued. One indication was provided by the total amount of budgetary subsidies, but that was only a part of the overall support of the public enterprise sector.

The authorities intended to proceed within the coming year to implement financial reform, the staff representative went on, although it was not certain that it would be completed by the end of the year. Fiscal reform would begin with a reduction in marginal tax rates, which the staff could support provided it was accompanied by measures to widen the tax base, to improve enforcement, and to close the large loopholes in the existing system of direct taxation.

The staff had not examined on a case-by-case basis the criteria for identifying viable ailing enterprises, the staff representative said. One criterion the authorities had mentioned was whether net operating profits could be re-established within a reasonable time, but such factors as strategic importance and size of manpower would almost certainly play a part in establishing viability. As for the financing arrangements involved in the restructuring of ailing enterprises, they essentially consisted of compulsory takeovers by creditors, mainly the banks, and the conversion of the debt into equity. However, data provided to the staff on the development of operating profits of the ailing enterprises indicated that in many cases there had been an improvement in net operating profits beyond the simple financial restructuring.

Mr. Kyriazidis remarked that the authorities had not been able to agree with the staff regarding an acceleration of the slide of the effective exchange rate, which was currently limited to compensating for inflation differentials, because it could have caused serious adverse effects. The authorities, of course, realized that taking that approach implied that a greater burden for balance of payments adjustment would have to be carried by fiscal and monetary policies. The matter was delicate, and, unfortunately, the staff report had been leaked to the press, whose attention had focused on the particular recommendation regarding exchange rate policy. It had caused some difficulty for the Government.

Whatever measures were taken regarding the social security problem would yield their results only in the medium term, Mr. Kyriazidis continued. Like adjustments with qualifications for pensions--particularly disability pensions--social security adjustments could not be applied retroactively; they could only be made effective for the future. Meanwhile, the effect of the social security deficits on the fiscal situation would have to be resolved or absorbed by other resources and other adjustments in the overall fiscal policy of the Government. It should be noted, however, that part of the social security deficits were explained by the Government's assumption of extraordinary burdens during the 1950s and 1960s. Highly populated Greek communities living abroad--in Istanbul and in Egypt, for example--came to be covered under the social security system with no corresponding contributions.

Like the social security and pension problems, the Seamen's Fund had represented a burden for the Government, Mr. Kyriazidis noted. The reduction in employment in shipping was not only due to the shipping crisis. Tourism and other areas of employment had experienced rapid development and provided expanding employment opportunities. People became reluctant to work in the shipping sector, and, thus, the drawdown on the Seamen's Fund became a serious problem.

It was difficult to assess the adequacy of interest rates at the moment, Mr. Kyriazidis commented. The interest rates applicable to about 55 percent of credit from the commercial banking system were currently about 22 percent, which was clearly positive by more than 6 percentage points in comparison with the rate of inflation, and they were freely determined. In fact, the rates had had a restraining effect on the demand for credit from the business sector. For other rates, it was difficult to judge. During the summer months, it appeared that the treasury bill rates, ranging from from 17.5 percent to 19.5 percent, had been adequate because a vivid interest had developed for investment in such paper, which, the authorities hoped, would continue and expand. Whether the savings deposit rate of 15 percent tax free was adequate or not was difficult to say, particularly since the expansion of deposits continued at a rate higher than the increase in GDP. Therefore, judging the adequacy of interest rates was difficult. In order to reduce the rate of growth in M3, some people had recommended a reduction in the interest rates rather than a further increase in positive rates.

The pace of financial reforms had been left to the discretion of the Bank of Greece, Mr. Kyriazidis continued. The Bank of Greece was determined to proceed as fast as possible in parallel with the progress made toward the stabilization of the economy, and most reforms should be carried out within a year or so.

In addition to the new incomes policy, the Government had taken measures to promote flexibility in the labor market, Mr. Kyriazidis went on. All along, the Government had had to accept the social partners' resistance to the new programs. Considerable resistance had been particularly demonstrated by the workers in trade unions. Therefore, existing legislation had been applied liberally to allow manpower in the private sector to adjust to the situation. Other measures were currently being taken to increase overall flexibility in the labor market--the liberalization of rules regarding part time employment, introduction of fourth shifts, and the regulation of overtime in consultation with the social partners. Those developments should be viewed in conjunction with the adjustment in incomes policy that were designed to permit a widening in wage differentials.

In making clear its approach to the tax reform issue, the Government had established the qualification that adjustments in the tax rates would have to be accompanied by measures to expand the tax base, Mr. Kyriazidis noted. It was essential to safeguard total tax revenue even in the short run.

The possibility of restructuring ailing enterprises had been based on the principle of commercial viability, Mr. Kyriazidis remarked. Unprofitable operations were being closed; those that were potentially profitable were being studied to see if modernization would help. With the assistance of consultants, the Government was identifying the market value of those enterprises in order to reprivatize them through sales of stock on the stock exchange.

Full liberalization of external transactions would proceed within the framework of Greece's integration into the European Communities and the completion of the unified market by 1992, which would involve all foreign exchange transactions and capital movements, Mr. Kyriazidis said. Consequently, the time frame was quite clear. Prior to that time, the regulatory tax problem and all restrictions on imports and exports would disappear. Also, there would be a gradual liberalization of exchange control regulations in services, and, of course, there had already been a substantial liberalization of investments and repatriation of capital and profits. Therefore, sometime before 1992, Greece would be able to assume the obligations of Article VIII, assuming the prerequisite continued success of the adjustment effort.

The Acting Chairman then made the following summing up:

Directors welcomed the progress in the external accounts and the inflation performance of the Greek economy since the inception of the stabilization program. They noted, however, that this progress has been slower and weaker than initially envisaged, that the rate of inflation remained significantly higher than in Greece's main trading partners, and that Greece's debt-servicing requirements were high. They, therefore, urged the authorities to continue the adjustment effort in 1988, beyond the formal expiration for the program, with a view to securing significant progress in both areas.

Directors welcomed the progress made in reducing the fiscal deficit in 1986, but expressed concern at the prospect of a significant excess of the public sector borrowing requirement in 1987 over the initial budget target. While noting the corrective measures taken, they urged the adoption of adequate additional measures also with a view to achieving a sizable further improvement in 1988. They recommended that fiscal adjustment over the next few years be sought primarily through containment of public expenditures, increases in prices of public services, and possibly some petroleum products, cuts in subsidies, strengthening the finances of the social security funds and the public enterprises, and widening the tax base. In this respect, Directors welcomed the introduction of the value-added tax in 1987 and encouraged the authorities to press ahead with a comprehensive reform of taxation, in particular, direct taxation.

Directors also noted with concern the likelihood of significant slippages in the implementation of the monetary program in 1987. They welcomed the recent measures to liberalize selected interest rates and to tighten bank liquidity, and urged that further steps be taken to increase the attractiveness of treasury paper to the nonbank public, with a view to absorbing liquidity in the economy and promoting over time the developments of capital markets. Directors considered that the authorities' intention to move to a more flexible incomes policy in 1988 would require increased reliance on monetary policy and fiscal restraint to secure the desirable further moderation of costs and prices. The pursuit of a disinflationary monetary policy would be greatly facilitated by increased flexibility of interest rates.

Directors welcomed the improvement in business confidence. They noted the contribution made by the authorities' incomes policy to the domestic and external adjustment in the Greek economy in the last two years, and underlined the importance of maintaining labor costs in 1988 within the framework of a more flexible policy, permitting a greater degree of wage differentiation. A number of Directors felt that moderation of the degree of wage indexation or its abolition could make a significant contribution to the attainment of this objective. They supported the authorities' intention to promote productivity growth through easing restrictions on the use of manpower. Directors welcomed the structural reform measures taken in several areas so far and considered that early and determined progress in liberalizing the labor, goods, and financial markets would help strengthen confidence and support the incipient recovery of investment and also of nondebt capital inflows from abroad. Directors noted that public enterprise reform to improve efficiency and productivity would also contribute to improved economic performance.

Directors noted the authorities' objective to secure the containment of the current account deficit of the balance of payments to a level consistent with the stabilization of external debt and urged them to gear policies for 1988 toward this end. They underlined the importance of a strong growth of exports for the simultaneous achievement of this objective and of a moderate recovery of GDP growth.

The prospective integration of the Greek economy in the European Communities underscored the importance of a stable financial environment to be achieved through the rapid further reduction of the public sector borrowing requirement and a tighter monetary policy. It also underscored the critical importance of maintaining external competitiveness. To that effect, a number of speakers supported the emphasis of the authorities on fiscal and monetary policy and on containing labor costs and raising productivity rather than an accommodating exchange rate policy. That approach, however, required appropriately strict demand-management and incomes policies.

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

The Executive Directors then took the following decision:

1. The Fund takes this decision in concluding the 1987 Article XIV consultation with Greece, in the light of the 1987 Article IV consultation with Greece conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. The restrictions on the making of payments and transfers for current international transactions are maintained by Greece in accordance with Article XIV.

Decision No. 8699-(87/141), adopted
September 18, 1987

3. LEBANON - 1987 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1987 Article IV consultation with Lebanon (SM/87/150, 7/1/87; and Cor. 1, 8/26/87). They also had before them a background paper on recent economic developments in Lebanon (SM/87/153, 7/7/87).

The staff representative from the Middle Eastern Department made the following statement:

> The economic situation in Lebanon has become very worrisome. The cycle, outlined in the staff report, wherein the massive fiscal deficit has accelerated inflation and depreciation of the pound, which in turn have expanded government spending and enlarged the deficit, has intensified. The rate of inflation is officially reported to have reached 300 percent in the first eight months of the year, while the pound has depreciated from LL 120 to the dollar at the time of the consultation discussions with the Fund staff in mid-May to LL 300 to the dollar recently.
>
> Despite the 50 percent increase in July for domestic prices for petroleum products, the Bank of Lebanon estimated at the beginning of August that the petroleum subsidy would reach LL 40 billion in 1987--compared to an agreed estimate of LL 30 billion in May--pushing the public sector deficit for this year to LL 80 billion from the May estimate of LL 60 billion. The ongoing depreciation of the Lebanese pound necessitates further upward revisions to estimates of the petroleum subsidy and public sector deficit.
>
> The response of potential creditors to the autonomous fund that was outlined in the staff report has been very cautious.
>
> The authorities have also been considering selling part of the Bank of Lebanon's gold stock--9.2 million ounces, worth about $4.5 billion at prevailing market prices. In recent meetings with the authorities, the Fund staff has again cautioned that the principal from any sale of gold should not be used for exchange market intervention. Experience in 1983-84, when $2 billion of foreign exchange reserves were used to support the pound, underlines the limited impact that intervention can have in Lebanon's situation.

Mr. Finaish made the following statement:

> Economic developments in Lebanon over the past decade have reflected the exceptionally difficult security situation in the country. Since 1985, however, the economic deterioration has accelerated rapidly despite the reduced level of armed conflict.

This deterioration can be seen most starkly in the dramatic depreciation of the Lebanese pound over the past two years. The pound, which traded at LL 18 to the dollar at the end of 1985, depreciated to about LL 87 to the dollar by the end of 1986 and reached LL 120 to the dollar during the consultation discussions in May 1987. The pound has continued to slide since then, and over the past few weeks the exchange rate has ranged between LL 260 to the dollar and LL 300 to the dollar. Whereas such a rapid depreciation of the currency would have serious economic implications for any country, it is especially so in an open economy which imports more than three quarters of its needs, as is the case in Lebanon.

As one would expect in these circumstances, the rate of inflation has accelerated concomitantly with the decline in the Lebanese pound. The available data indicate that consumer prices, which doubled in 1986, rose at an annual rate of 400 percent in the first half of this year and have probably accelerated further since then. However, wage increases in both the public and private sectors fell substantially short of the increase in prices. This was due both to the excess supply of labor and the fact that inflationary expectations had not become as deeply entrenched as in countries with a long experience of high inflation rates. The effect of the sharp decline in real wages on income distribution--especially between wage earners and those who derive their incomes from remittances and other foreign flows--has been quite substantial. Moreover, although by now very little of the private sector's financial assets are kept in Lebanese pounds, the timing chosen by different individuals to convert their assets to foreign currency has also had a substantial distributional effect.

The available data on the balance of payments are sketchy, but it appears that the impact of the sharp depreciation of the pound on trade flows has been quite large. Imports in 1986 are estimated to have declined by about one third of their 1984 level. The recent estimates of exports also show a significant increase. For example, the most recent estimates of the Ministry of Petroleum and Industry indicate that industrial exports for the first eight months of 1987 were equal to total industrial exports in 1986. This surge in exports is expected to strengthen further with the increased competitiveness associated with the continued depreciation of the Lebanese pound.

Notwithstanding the positive effect on the export sector, the overall impact on the economy of the rapid depreciation has been quite negative. It should not be surprising, therefore, that the main preoccupation of the Lebanese authorities in the recent period has been to find ways of slowing down the slide in the Lebanese pound.

The authorities are in agreement with the staff that the exchange rate trend is a reflection of the fast growing borrowing requirement of the public sector and the declining confidence of the private sector. Clearly, a reduction in the fiscal deficit is essential if the trend is to be reversed. Equally clear, however, are the constraints that make fiscal adjustment in Lebanon a very difficult task.

On the revenue side, for example, an important constraint is the fact that most ports in the country--which traditionally have been the major source of revenue from import tariffs--are currently outside the control of the Government. Another constraint on taking new revenue measures is the fact that the Parliament has not enacted the budget law for any year since 1984.

On the expenditure side, and other than interest payments that have been increasing rapidly owing to the rise in the domestic debt of the public sector, the two major spending items are the petroleum subsidy and, to a lesser extent, wages and salaries. With respect to the latter, it should be noted that the wage and salary increases granted in 1986/87 were substantially lower than the rate of inflation, which, as I mentioned earlier, resulted in a drastic reduction in real incomes of public sector employees. This, coupled with the freeze imposed since 1985 on most public sector hiring, makes it difficult to envisage a further tightening of this expenditure item.

The petroleum subsidy, which is projected to amount to one half of the total deficit in 1987, is by far the most worrisome aspect of the fiscal situation. This is not only because it is the major contributor to the rise in public debt, and therefore to the rapid increase in interest payments--which amounted to about twice the level of total revenue in 1986--but also because the magnitude of the subsidy is a direct function of the exchange rate. The authorities are concerned that with the continued depreciation of the pound, the petroleum subsidy is leading to a vicious circle of growing deficits and further depreciation. The 50 percent increase in petroleum product prices the previous June has been more than offset by the rapid depreciation that occurred since then. There is currently an intense debate going on in Lebanon regarding the elimination of the petroleum subsidy, and the finance ministry has indicated its intention to link domestic prices directly to the exchange rate. In the meantime, the central bank has been reluctant to open petroleum credits until the subsidy issue is settled. As a result, shortages have occurred and actual prices have risen to about four times the official levels in certain areas of the country.

Over the past two years, monetary policy has aimed at mitigating the impact on liquidity of the rising fiscal deficit. Toward that end, commercial bank reserve and treasury bill portfolio requirements were tightened in 1986. Recent developments, however, have severely constrained the ability of monetary policy to play its role. The rapid increase in the foreign currency component of bank deposits--75 percent of total deposits in the first quarter of the year--and the fact that very little additional lending in Lebanese pounds is being extended by banks have been major complicating factors. This notwithstanding, the central bank has taken further tightening measures subsequent to the consultation discussions. On July 6, 1987, bank reserve requirements were raised from 13 percent to 16 percent and the marginal treasury bill portfolio requirement was raised from 60 percent to 75 percent. In addition, the penalty interest on excesses in banks' foreign exchange positions was increased from 20 percent to 120 percent.

The authorities agree with the staff that under the present circumstances the role of interest rates in the conduct of monetary policy is limited. Clearly, given the present rate of inflation and the relative size of the domestic public debt, positive real interest rates are likely to lead to a substantial increase in the fiscal deficit and thus in the rate of liquidity expansion. In the meantime, the Bank of Lebanon will continue its flexible policy by discounting treasury bill sales to the private sector, depending on market conditions and taking into account the Government's interest expense.

Despite the financial instability which characterized the economy in the past two years, the condition of the banking system has actually improved during the period. This was due in part to increased earnings from the net foreign currency position of banks and continued prudence in refraining from distributing profits. Moreover, the fact that bank customers are concentrated in those sectors which benefited from the increased competitiveness of the economy has also strengthened the banks' financial position.

Regarding the policy on external reserves, there are two major issues. First, as far as gold reserves are concerned, there has indeed been a suggestion to sell a part of the gold holdings as reported by the staff. However, since this proposal did not receive enough support, it is not being actively pursued at present. Second, regarding the policy on foreign exchange reserves, the Bank of Lebanon has for the most part refrained from using those reserves in exchange market intervention in the recent period and intends to continue this policy in the future. However, given the large fluctuations around the exchange rate trend, which sometimes exceeds 10 percent a day in both directions, it may be necessary from time to time to intervene in a limited way to smooth out such speculative fluctuations. In its efforts to reduce exchange market speculation, the Bank of Lebanon has also taken measures to discourage the growth of the Euro-Lebanese pound market which, in the authorities' view, is being used as a vehicle for speculation against the Lebanese pound. Moreover, the authorities have proposed that a special autonomous Fund, financed by deposits from the central banks of a few friendly countries, be established. In their view, such a fund could help stabilize speculative pressures on the exchange rate even if it is not used for market intervention. Although Lebanon's external debt is relatively small, in March 1986 the Bank of Lebanon decided that it would not guarantee any new external borrowing by the public sector with the exception of trade credits for certain imports.

In conclusion, the current circumstances in Lebanon make it very difficult to adopt and implement a comprehensive set of policies to deal, in a fundamental way, with the deteriorating economic conditions. The authorities are hopeful, however, that in the coming period they will be able to at least slow down that deterioration by adopting measures, including the elimination of the petroleum subsidy, which will alleviate the pressures on the fiscal position and help stabilize exchange market expectations. In order to help contain the downward trend in the economy and to assist in laying the grounds for a fundamental solution, Lebanon will need all the support it can get from the international community. Finally, the authorities continue to be committed to a free exchange and trade system, which has helped the economy maintain some resiliency even under the present trying circumstances.

Mr. Al-Assaf made the following statement:

In an environment characterized by serious lack of security, widespread disruption in the transportation network, and destruction of the country's physical capital, it is difficult, if not impossible, to design and implement appropriate economic policies. This is all the more true in Lebanon since there is also a lack of reliable statistical information on which to base policies and an erosion in the Government's control over the economy. Under these difficult circumstances, output has continued to fall steeply, inflation has continued to accelerate rapidly, and the exchange rate of the Lebanese pound has continued to depreciate sharply.

It is clear that the task facing the authorities is how they can best contain the deterioration in the economic situation until a lasting improvement in the political and security situation can be achieved. Unfortunately, even this task is made difficult by the narrow range of policy tools at the authorities' disposal and the risks involved in introducing necessary, but unpopular, economic measures. For example, while I agree with the staff on the need to reduce subsidies and contain government spending, I share the authorities' concern that in view of the prevailing political climate and widespread poverty, an adjustment that is too rapid may turn out to be counterproductive.

While waiting for a durable solution to the Lebanese political and security situations, the authorities should concentrate their efforts on the fiscal front. The growing fiscal deficit is clearly an important factor contributing to the recent sharp acceleration in inflation and exchange rate depreciation. The objective should be to reduce considerably the fiscal imbalance by both improving revenue performance and containing the growth in government spending. In this connection, I commend the authorities for their continued adherence to restrained wage and employment policies in the public sector, for carefully scrutinizing public agencies' spending, and for the recent commendable adjustment in the subsidy for petroleum products. While there is a clear need to improve government revenue performance, it must be recognized that the Lebanese legislature had not approved a budget since 1984, making it legally impossible for the authorities to introduce new revenue measures, in addition to the difficulties in implementing such measures.

As the experience of other countries has shown, without a substantial improvement in the economic environment and appropriate economic policies, exchange intervention cannot have a lasting effect. In this connection, I am not sure if the authorities should use the country's gold for this purpose at this time; the underlying economic fundamentals are not there to ensure the success of such a policy. Perhaps the staff or Mr. Finaish could elaborate more on this issue.

In conclusion, as the authorities realize, the challenge ahead will be to stabilize present imbalances and limit the loss in output and income. Only with a much improved security situation can the country aspire for a return to a sustainable growth with balance of payments viability.

Mr. Marcel made the following statement:

This Article IV consultation gives my authorities the opportunity to express again their very keen interest in a country with which France has a very old and close relationship. I would like to reiterate that France will continue to lend its full support to Lebanon in bilateral relations as well as through its active participation in those international institutions which may be called upon to help this country.

It is not necessary, of course, to emphasize the fact that this country is in an extremely difficult situation. The authorities face a difficult task, since the security situation narrows the range of policies that can be implemented. Therefore, I would pay particular homage to the authorities who, despite the prevailing conflict and disruption, make heroic efforts to maintain the foundations of a trade-based economy. Although the authorities have also made great efforts to implement economic and financial policies, the economic situation remains worrisome.

The size of the fiscal deficit is disquieting, since it doubled in 1987; this large deficit has caused an acceleration of the rate of inflation and depreciation of the pound, creating a vicious circle: the compounding of interest on the debt incurred to finance the fiscal deficit has automatically increased the deficit further. Furthermore, the monetary financing of the fiscal deficit caused an excess of liquidity, contributing to increasing inflation and depreciation of the pound.

Thus, we encourage the authorities to strengthen fiscal policy, even though recent efforts are noteworthy. We are pleased that recent salary increases for public employees were well behind the rate of inflation. Also, the freeze on hiring new government employees and the proposal to link petroleum product prices automatically to their pound costs are appropriate measures. However, we urge the authorities to continue their efforts to reduce the fiscal deficit. At the same time, it is clear that the financing of the fiscal deficit and the continued shift from pounds to foreign currency deposits have eroded the effectiveness of monetary policy. Efforts should continue to slow the growth of credit to the private sector. Nevertheless, it would seem appropriate to pursue a flexible approach to interest rates in order to avoid the acceleration of the public debt service increase. Lastly, maintaining a flexible exchange rate system appears to be an adequate policy, particularly to maintain central banking reserves.

We know that the size of the task is considerable; however, we would like once again to offer our encouragement in this effort. We are convinced that making this effort is important in preparation for the welcome day when the political situation improves. I sincerely hope that it will be very soon.

Mr. Templeman made the following statement:

Let me express my admiration for the efforts of the Lebanese authorities in maintaining cooperative ties with the Fund through these consultations, notwithstanding the very difficult security situation in Lebanon. Under the circumstances, it is particularly important that the authorities and the Fund work together to try to monitor economic developments as closely as possible and for the Fund to provide its advice to help them cope with an extremely difficult problem of economic management.

The staff report suggests that some progress has been made in the past year in maintaining economic activity and in sustaining exports, although the inadequacy of data on the national accounts and the balance of payments make it difficult to know very clearly just what is going on. To the extent possible, we hope that the authorities and the Fund will work to try to improve the quality of the data.

Of course, a much more serious problem is the fact that the security situation severely limits the ability of the authorities to deal with their grave economic problems. However, I would stress the point made by the staff that there are some things that can be done. Indeed, it is more important than ever that the economic tools which are still available be used in the most effective way possible.

The fiscal tool is the critical one, and we concur with the staff that the authorities must carefully set their priorities and focus their energies on a few key revenue and spending actions for containing the fiscal deficit. Without success in that area there is a real danger that the vicious cycle referred to in the staff report and the opening statement by the staff could get out of control. Indeed, the triple-digit inflation that has recently emerged may not yet be an ingrained feature in inflationary expectations of the people. However, quick action on the fiscal deficit will be required to prevent this from happening. The staff suggests that the ways to generate revenue were via the customs valuation, land registration fee, and real estate capital gain routes. On the expenditure side, some progress is being made in containing wage costs and the careful setting of priorities for public investment is also important. But little progress can be made in reducing the fiscal deficit so long as the petroleum subsidy continues on such a large scale. Even substantial ad hoc price increases in an environment of a rapidly depreciating exchange rate clearly will not suffice; hence there is a need for a more automatic mechanism to prevent future subsidies.

Until the fiscal deficit is reduced, control over domestic liquidity will continue to be very difficult. Since confidence factors have already led to a very widespread dollarization of the money supply, there is little margin for error in controlling credit to finance the budget deficit and credit to the private sector. Some credit restraint through use of the reserve requirement and treasury bill requirement may be possible, and we welcome the latest measures taken in July. We are less comfortable with efforts to prevent speculative lending by the commercial banks and to limit the growth of the Euro-pound market, as well as with regard to the possibility of direct credit controls. But, under the exceptional circumstances facing the monetary authorities, temporary resort to such measures may be unavoidable.

A flexible interest rate policy is also essential. In fact, it is easy to see why domestic savers and investors do not wish to hold pound-denominated financial assets, given the extremely negative real rate of return. Still, we recognize the danger of a vicious cycle being set in motion from rising nominal interest rates. Thus, a testing of the market, as suggested by the staff, seems the most prudent approach to interest rate policy. Also, measures being taken or being discussed between the Bank of Lebanon and the commercial banks to preserve the soundness of the banking system are important.

Lack of confidence and market pessimism have clearly contributed to weakness in the exchange rate and, perhaps, to a downward movement in the rate. While psychological factors may be important, it is also true that inadequacies in fiscal and monetary management must be contributing to the volatility and weakness of the pound. Under the circumstances, it is commendable that the authorities are continuing to maintain a free exchange system.

A strengthening of the country's international reserve position could play a role in maintaining a degree of confidence. We note the existence of about $4.5 billion in gold holdings. We wonder whether the staff has any specific ideas as to how these gold stocks might best be employed to deal with Lebanon's difficult international liquidity and financial market confidence problems. However, we would certainly not wish to see any proceeds from gold sales dissipated through large-scale exchange market intervention.

In conclusion, while the authorities are confronted with some extremely difficult economic problems, some policy tools can still be used. Indeed, it is more important than ever to use them in the most effective way possible. We hope that the authorities will do so, and we welcome the continuation of regular consultations with the Fund on a 12-month cycle.

The staff representative from the Middle Eastern Department said that Lebanon's gold stock was worth roughly $4.5 billion. The value of the gold in pounds exceeded the pounds in circulation as currency or as deposits held with banks in Lebanon. In fact, the authorities had tried to make the public aware that in a sense the pound was undervalued. To sell the gold would require approval by Parliament. The staff's position was that if the gold was sold, the proceeds should not be used for intervention in the exchange market but that the principal should be invested in conventional foreign exchange assets. Thus, the return on the investment could be used for public sector expenditures, and the Government would not have to resort to the foreign exchange market in Beirut.

If the petroleum subsidy were removed, the result would be an increase in the cost of living. The large amount of liquidity injected into the system by the petroleum subsidy was having a general impact on prices. The low retail price of petroleum products was encouraging illegal exports.

Therefore, by raising retail prices it would discourage some of the illegal exports of petroleum and help to reduce the general rate of inflation.

Some revenue measures could be taken, the staff representative noted. The customs exchange rate, which was currently LL 6 per dollar, could be brought up closer to the free market rate. Of course, increasing the customs exchange rate would encourage the use of the illegal ports. However, automobiles had to be registered by their owners, and therefore they had to pay customs duties. Thus, there would also be a reduction in the number and value of automobiles imported, but on balance the revenue effects would probably be positive.

Mr. Finaish said that to understand the situation in Lebanon was to recognize the constraints on policymaking. The relevant question was what could be done in the short run and, then, later on. The authorities were trying to do their best given the difficult circumstances, but they needed and deserved any understanding, sympathy, and aid that they could get on the regional and international level. No fundamental solutions could take place until the problems of security and politics had been dealt with. In the meantime, economic policy had to be conducted within the obvious constraints mentioned in the staff report and by Executive Directors.

There was very little that could be done on the expenditure or revenue side, Mr. Finaish continued. When the authorities were not in control of certain areas, it was difficult to collect taxes from them. If the ports were not under the control of the Government, then it was difficult to collect customs duties; furthermore, if the Government raised customs duties, it risked the possibility that imports would be shifted to illegal ports. There were some people in Lebanon that argued that the best way to put illegal ports out of business was to eliminate customs duties all together.

The petroleum subsidy was a major cause of the fiscal deficit, and something had to be done about it if, indeed, that had not already happened, Mr. Finaish went on. It was difficult in the best of circumstances to raise prices of petroleum products, even in countries that were in better circumstances. In Lebanon, which was politically fragmented, it was almost impossible to make decisions on such an issue. Also, there were other aspects of the problem; for example, in Lebanon people relied basically on private transportation. One study cited that there was one car for every eight Lebanese. Furthermore, the prices of petroleum products had already been increased by 50 percent in June. To eliminate the subsidy on top of that increase would put a large number of families in the position to argue that there was no public transportation. The authorities were in a difficult spot. Under the circumstances, the workers already paid most of their salaries just to commute to work. The average salary at best was probably about $40 per month in dollar terms. Minimum wage was $15.

Nonetheless, the authorities were attempting to improve the public transportation, which would make the elimination of the petroleum subsidy easier, Mr. Finaish noted. Recent reports from Lebanon would indicate that subsidies had already been lifted. The most recent information, a telex from the Governor of the Bank of Lebanon only three days previously, indicated that the petroleum subsidy was no longer a major issue. In the previous few weeks, the authorities had stopped making appropriations for oil imports and the central bank had been reluctant to open petroleum credits. One result of that situation was that unofficial prices of petroleum products had risen sharply--in some areas up to four times the official price. The private sector was buying oil and selling it at market prices.

The situation, albeit extremely difficult, was not without hope in a country such as Lebanon, Mr. Finaish remarked. There were elements of underlying strength--the resilience of the people and the traditional openness of their economy. The Bank of Lebanon had its $4.5 billion in gold and about $600 million in foreign exchange. The private sector's holdings of foreign currency had risen to about $6.5 billion by the end of 1986. These statistics did not mean that the economic situation was not serious, but it provided some hope that when the factors that had led to the recent deterioration were dealt with, the underlying strengths could be counted on to effect a good recovery and to restore the financial stability that Lebanon had traditionally enjoyed. Actually, financial stability in Lebanon had existed up until four years previously, after which production had dropped significantly. However, recently both agriculture and industrial output had showed significant increase, which had not happened in the previous four years. Therefore, until there was a fundamental change in the political and security situation, the Lebanese were doing the best they could to deal with their problems.

The Acting Chairman then made the following summing up:

Directors were in broad agreement with the views expressed in the staff appraisal of the 1987 Article IV consultation with Lebanon. They recognized that the economic deterioration and disruption during recent years were mostly the result of difficult security and political conditions that have led to declines in output and income and have severely hampered the efforts to limit the public sector deficit and reduce the expansion of credit to the private sector. As a result, the public sector deficit widened sharply, monetary growth increased, the Lebanese pound depreciated precipitously, and the rate of inflation accelerated.

Directors noted that the economic situation and prospects have become very worrisome. Despite the recent measures to contain current outlays, the petroleum subsidy, together with growing interest payments on government debt, threatened to increase the public sector deficit further, leading to spiraling depreciation of the pound and hyperinflation. While recognizing that economic recovery could only be attained with a fundamental improvement in security conditions, Directors believed that some measures could be taken to improve public finances, including a closer link of petroleum prices to costs, as well as efforts, where possible and recognizing circumstances, to curtail spending on activities that were not directly productive, and to raise revenues. Although the effectiveness of monetary policy has been greatly diminished, the authorities should persevere with their efforts to limit credit expansion to the private sector, and with their flexible approach to interest rate determination.

Directors welcomed the Bank of Lebanon's determination to avoid large-scale intervention in support of the pound, especially in view of its limited potential for success and of the need to conserve gold and foreign exchange reserves, and they supported the authorities' cautious approach to foreign borrowing.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/87/140 (9/16/87) and EBM/87/141 (9/18/87).

4. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 87/28 through 87/30 are approved. (EBD/87/232, 9/11/87)

Adopted September 17, 1987

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/87/202 (9/15/87) and EBAP/87/203 (9/16/87) and by an Advisor to Executive Director as set forth in EBAP/87/203 (9/16/87) is approved.

APPROVED: May 3, 1988

JOSEPH W. LANG, JR.
Acting Secretary