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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/141

10:00 a.m., August 29, 1986

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	J. R. Ismael, Temporary
	M. Lundsager, Temporary
	D. C. Templeman, Temporary
	H. G. Schneider
M. Finaish	
	M. Sugita
	B. Goos
	Jiang H.
J. E. Ismael	
	H. A. Arias
T. P. Lankester	M. Foot
	O. Isleifsson, Temporary
	G. D. Hodgson, Temporary
	A. Abdallah
	M. A. Weitz, Temporary
Y. A. Nimatallah	
	J. de la Herrân, Temporary
H. Ploix	S. de Forges
	J. de Beaufort Wijnholds
C. R. Rye	
G. Salehkhou	O. Kabbaj
A. K. Sengupta	A. S. Jayawardena
	N. Kyriazidis

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

Also Present

IBRD: F. Temple, South Asian Regional Office. Asian Department: P. R. Narvekar, Director; K. A. Al-Eyd, B. W. Ames, B. Banerjee, S. P. O. Itam, D. Villanueva. European Department: L. A. Whittome, Counsellor and Director; L. M. Beleza, M. T. Hadjimichael, P. C. Leme, P. Masi, T. H. Mayer, S. Mitra, T. M. Ter-Minassian. Exchange and Trade Relations Department: J. T. Boorman, E. H. Brau, J. H. Felman. Fiscal Affairs Department: T. Catsambas. Legal Department: P. L. Francotte, L. Maktouf. Advisors to Executive Directors: A. A. Agah, W.-R. Bengs, M. B. Chatah, I. Puro, M. Z. M. Qureshi, R. Valladares. Assistants to Executive Directors: O. S.-M. Bethel, V. Govindarajan, G. K. Hodges, J. M. Jones, S. King, R. Msadek, G. Schurr, G. Seyler, L. Tornetta.

1. BANGLADESH - STAND-BY ARRANGEMENT - REVIEW AND MODIFICATION

The Executive Directors considered a staff paper (EBS/86/176, 8/5/86; Cor. 1, 8/28/86; and Sup. 1, 8/28/86) on the first review under the 19-month stand-by arrangement for Bangladesh approved on December 2, 1985 (EBS/85/251, 11/12/85).

Mr. Sengupta made the following statement:

> The economic program for 1985/86 was expected to bring about an improvement in the balance of payments while achieving a real growth in GDP of about 4 percent. The results achieved in the implementation of the program in its first year have been substantial. The performance criteria for the quarters ending December 1985 and March 1986 have been met fully; the latest information circulated by the staff indicates that end-June targets have also been largely met. In addition, GDP has grown by 5 percent instead of the 4 percent that had been targeted earlier. There has been substantial improvement in agriculture, mainly rice and jute production. The rate of inflation has been contained at 9.7 percent, compared to the program target of 12 percent. Food supplies have improved, leading to a decrease in food prices and a reduction in foodgrain imports. The increase in workers' remittances--even without much expansion in the economies of oil producing countries--reflects to a large degree the growing confidence in the economic management of Bangladesh. Despite the sharp deterioration in the external terms of trade and a fall in the f.o.b. value of exports--even though the volume of exports had increased by as much as 22 percent--all those economic developments have led to a reduction in the current account deficit by about $217 million, which was equivalent to 2 percent of GDP. This has resulted in an increase in the overall balance of payments surplus of $78 million, which is well above the program target of $30 million. As such, international reserves have improved, from 1.8 months' worth of imports in 1984-85 to 2.3 months' worth of imports.
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> In the fiscal area, there was a deviation of only 0.4 percent of GDP from the program target for 1986. There had been a shortfall in the revenues, which had occurred mainly in foreign trade-related customs duties, sales taxes, and excise duties. Revenue expenditure had increased because of a larger than anticipated salary increase under the new pay scales; an increase in grants to nongovernment education institutions; and an increase in foreign debt service payments, owing to a depreciation of the taka. In nominal effective terms, the taka had depreciated by about 22 percent, which had also caused an increase in development expenditures. The Government has been making serious attempts to reduce the present heavy dependence on foreign trade

taxes by broadening the tax base. This has resulted in a fall in the share of foreign trade taxes from 53.7 percent of total tax revenue in 1984/85 to 50.9 percent in 1985/86.

Monetary targets have been achieved, and monetary restraint supported by increasingly positive interest rates and a restrictive refinancing policy. Bangladesh has continued with the policy of a flexible exchange rate, together with an expansion of the secondary market. Administered prices of natural gas, electricity, fertilizer, and foodgrains have been raised, resulting in a substantial reduction in subsidies. In sum, the 1985/86 program has been very successful.

In 1986/87, Bangladesh intends to consolidate the stabilization effort to further reduce the rate of inflation, while at the same time initiating structural measures to promote economic growth. It is expected that the current account deficit will be contained at about 6.6 percent, a real GDP growth of about 5 percent will be achieved, and the inflation rate will be reduced to about 8.5 percent. The overall balance of payments is expected to record a surplus of $40 million. The aim of fiscal policy will be to reduce the overall budget deficit to 7.2 percent of GDP. The Bangladeshi authorities are aware that in order to achieve those results it is important, among other things, to strengthen domestic resource mobilization. To achieve that objective, the authorities have undertaken a number of measures, including taking advantage of the gains of the recent oil price decline by increasing the customs duties and modifying the tax structure to promote investment in export industries. The authorities have also initiated a review of tax policy and administration during the current year with technical assistance from the Fund and the World Bank.

I would like you to take note of the fact that the Government has taken a number of important steps in the area of subsidies on food and fertilizer. The total quantity of foodgrains for distribution under the Public Foodgrain Distribution System (PFDS) has been reduced with a view to reducing the amount of subsidy in 1986. The unit subsidy would be reduced appreciably by such measures as increasing the issue price, reducing storage and handling costs, and reducing storage losses. The recommendations made by a national committee formed to review the rationing system and the reduction of subsidies to privileged groups are presently under consideration by the Government. Measures have also been taken to reduce the allotment of grains in open areas in order to provide an increasing quantity of PFDS grain to rural centers. The prices of fertilizer were increased substantially during 1985/86 in order to eliminate the fertilizer subsidy. It is interesting to note that during 1986/87, the Government will also reduce the price of urea fertilizer by 4 percent to partly reflect the declining international price of urea, but again without resorting to any subsidy.

The Government is seeking technical assistance from principal aid donors and the World Bank for the public enterprise sector. The Government's industrial policy for 1986 will include measures for improving the operations of nonfinancial public sector enterprises and provision for transferring some of them to the private sector. It is possible that management contractors might be hired to operate and manage some of the major ailing enterprises. The Government has recently enacted legislation to provide greater autonomy to public sector corporations and enterprises.

Domestic credit expansion in 1986/87 will be contained in order to moderate inflation and consolidate the gains achieved in the external position. In their report, the staff has referred to the unanticipated higher credit requirements of the jute sector. In this context, I would like to bring to the notice of the Executive Board the difficulties faced by countries like Bangladesh with respect to raw jute and jute goods in the international market. The low price of raw jute has resulted in lower incomes to farmers which, in turn, has adversely affected the recovery of agricultural credit. Jute industries have also been incurring heavy losses over the past two years, thereby increasing pressure on the banking system. Therefore, the Government would strongly like to urge donors, particularly those importing jute and jute products, and international organizations, to help set up a buffer stock for jute in the interest of stabilizing export earnings and protecting the incomes of farmers.

A number of steps have been taken recently to improve loan recovery in the banking system and to enforce existing laws and regulations more effectively. Following a report recently submitted by the National Commission on Banking, Money, and Credit, the financial sector is being reviewed in detail.

The balance of payments position will continue to be under pressure in 1986/87. There is little prospect for a recovery in jute prices, and exports of the dynamic garment industry will be constrained by recent protectionist measures. Declining international oil prices will reduce the oil import bill; however, this reduction will be offset by an anticipated reduction in workers' remittances resulting from the deterioration of economic conditions in the oil producing countries. Given these developments, there will not be much room for further improvement in the current account deficit, which is expected to stabilize at about 6.6 percent of GDP. The staff is correct in noting that the medium-term balance of payments viability of Bangladesh will depend on successfully diversifying the narrow export base. A medium-term program for this purpose has been developed, covering tariff-free forms, simplification of investment sanctioning procedures, and strengthening of incentives for export-based industries through suitable modification of the import procedures.

As the staff report notes, considerable progress has been made over the past year toward unification of the dual exchange markets by significantly expanding the scope of the secondary market. The authorities intend to continue this policy and also maintain the margin of competitiveness gained by the taka through the recent devaluation.

The Government is committed to the success of this program, as evidence from the measures that it has already taken. The authorities believe that timely assistance from the Fund and the donor community are crucial to achieving that success.

Mr. Lankester made the following statement:

The Bangladesh authorities have made an encouraging start to the stand-by arrangement and have thus far met all the performance criteria. Despite the continuing weakness of many of Bangladesh's major export markets, a significant improvement in the current account balance has been achieved in the past year and the authorities have been able to add to their low level of reserves. Most importantly, there has been a strong rebound in the growth rate of 5 percent over the past year, together with a welcome fall in inflation.

Some difficulties appear to have arisen in the area of fiscal policy, where revenue has been lower than projected and expenditure somewhat higher. The revenue shortfall seems to have resulted not only from external developments, but also from lower yields from sales and excise taxes. It is encouraging to see that the Government has taken some important measures which should be of continuing benefit in the years ahead, including the reduction of fertilizer subsidies in 1985. It is also appropriate that the authorities have decided to eliminate the subsidy during the current fiscal year.

With respect to monetary policy, it is encouraging to see that the authorities have successfully met the targets under the program. The fairly cautious monetary stance envisaged for the rest of the program period appears to be appropriate in its objective of consolidating the inflation gains of 1985 and making further improvements in external performance. While we sympathize with the authorities' concern that credit to the agricultural sector should not be excessively curtailed, the weak outlook for jute prices and the structural weaknesses of the jute industry seem to suggest that additional credit to the sector would be a poor substitute for a more fundamental review of that sector's problems. We are pleased to see that the authorities have decided to undertake a review of the financial viability of the jute sector with the assistance of the World Bank. As to the establishment of a buffer stock for jute, my impression is that the demand for jute has been in a long-term structural decline for many years and, in those circumstances, it is questionable whether a buffer stock would be appropriate. I would be interested to hear the views of the staff on this issue.

The staff report notes that there have been significant positive benefits resulting from the depreciation of the taka, including a stronger response in workers' remittances and non-traditional exports. My impression is that the authorities have allowed the exchange rate to rise again. It seems that this increase should be looked at rather closely in view of the positive results that the more competitive exchange rate has had. If the exchange rate has been allowed to rise, I hope the authorities will keep the current rate under close scrutiny, particularly if the external situation does not improve as well as expected.

In sum, I would endorse the staff's view that the authorities have made a good start in meeting the objectives of the program. These efforts represent a good platform from which the authorities should be able to continue with the adjustment efforts. As to the long-term outlook, it is clear from the staff report that the economy continues to be marked by very serious structural problems. The staff's medium-term scenarios stress the magnitude of the problems of the external balance because they foresee little progress in strengthening reserves or reducing the current account deficit over the medium term. Steps to tackle these problems will be essential for ensuring the continued success of the stand-by arrangement and allowing the economy to achieve the strong growth over the medium term which is necessary to improve the present very low living standards.

I would like to mention three areas that seem to be important for Bangladesh's medium-term prospects and for which the Fund can provide assistance: monetary policy; exchange rate policy; and trade policy. The appropriate policies for these areas could be considered during the forthcoming negotiations on the structural adjustment facility.

The staff report emphasizes the continuing difficulties of the operation of monetary policy resulting from the large stock of nonperforming loans. Although the Government has already implemented a number of measures aimed at tackling this problem, these do not seem to have had a major effect as yet. It is important that the authorities are able to make significant progress in dealing with this issue. It is encouraging to see that they are seeking the technical advice of the Islamic Development Bank and the Asian Development Bank in this connection.

Although recent exchange rate measures have increased Bangladesh's competitiveness, the authorities continue to see the need to maintain a dual exchange rate system, together with a widespread system of import controls. Recent experience seems to document rather clearly the responsiveness of the economy to changes in the exchange rate. Thus, there appears to be a case for considering the unification of the exchange rate at a more competitive level. I wonder whether this subject might be discussed with the authorities during the forthcoming structural adjustment facility negotiations.

I have already alluded to the role that exchange rate policies can play in strengthening the external position. However, I would also support the approach that the authorities have taken in recent years to place greater emphasis on export promotion rather than import substitution. In following this approach, a significant number of measures have already been taken to liberalize the trade and payments system. Despite these measures, restrictive elements aimed at protecting domestic industry do continue on a rather large scale. There appears to be considerable scope for further liberalization of the system.

In conclusion, the authorities have achieved a commendable degree of success in meeting the objectives set out under the stand-by arrangement. I hope that they will be able to utilize this to continue with their structural adjustment efforts, the success of which will be crucial to the long-term performance of the economy.

Mr. Finaish made the following statement:

The Executive Board discussion held in December 1985 on the 1985 Article IV consultation with Bangladesh and the request for the current stand-by arrangement provided an opportunity for an exhaustive examination of economic and financial developments and policies in the country. Most of the comments made by this chair on that occasion remain valid.

Economic performance during 1985/86 appears to have been generally satisfactory. All performance criteria relating to the period have been met and most of the program targets have been reached, some even exceeded. The program outlined for 1986/87, covering the remaining period of the stand-by arrangement, should serve both to consolidate and extend the progress that is being made in carrying out necessary financial and structural adjustments. Accordingly, we congratulate Bangladesh on its performance under very difficult circumstances and support the proposed decision.

While the authorities deserve to be commended for the overall satisfactory record of the implementation of the envisaged adjustment, the staff has identified a few areas where policies need to be strengthened. First, a major factor underlying the weakness in public finances is the inelastic tax system. Enhancing the elasticity of the tax system and strengthening its base to reduce its vulnerability to external disturbances would require significant structural improvements in the system. In this connection, the intention of the authorities to undertake a review of tax policy and administration with technical assistance from the Fund and the World Bank is welcome. While efforts should be made to mobilize greater resources through taxation, it should be recognized that the country's taxable potential is limited by its extreme poverty. Second, given the significant role played by nonfinancial public enterprises in the economy and the potential contribution they can make to the domestic resource mobilization effort, the operational efficiency and financial performance of these enterprises are of particular importance. There appears to be a need to take steps to improve the functioning of these enterprises. Third, although the authorities have taken some measures to improve loan recovery by the domestic banking system, the persistence of the problem of inadequate loan recovery points to the need for additional and more effective measures. In that context, the comprehensive review of the financial sector that the authorities propose to undertake jointly with the World Bank should be particularly useful.

The staff's analysis of the economy's medium-term outlook emphasizes the importance of structural change with a view to diversifying the production and export base. Structural change facilitating economic diversification will be crucial to the objective of a satisfactory evolution of the external financial position over the medium term, together with the attainment of sustained and adequate growth to raise per capita income from the current very low level. In this context, the recent increase in some nontraditional exports is encouraging, although such exports still form a small proportion of total exports. The export orientation of the authorities' investment, trade, and exchange policies is also encouraging. An appropriate structure of incentives for the expansion and diversification of the output and export base would need to be complemented by adequate financing, both domestic and external, to support investment in the new areas of activity. The staff states on page 20 of the staff paper that "a medium-term program to encourage investment in export industries has been formulated with donor support." Some elaboration by the staff on this program would be helpful.

Adequate access to foreign markets would also be an important condition for the sustained growth of nontraditional exports. Protectionism in industrial countries poses a threat to Bangladesh's exports, in particular to the continued growth of exports of garments, an item that has shown the greatest dynamism among the country's nontraditional exports in recent years.

Finally, in view of the evident need for a medium-term framework for growth-oriented structural adjustment, and the country's dependence on concessional external resources, an arrangement under the structural adjustment facility could be particularly useful. It would be helpful if the staff provided information on the progress being made toward a possible arrangement under the structural adjustment facility. The staff should also comment on the question raised by Mr. Sengupta about the possibility of a buffer stock for jute. At the previous Executive Board discussion on Bangladesh, we had also raised a question about the possibilities for better management of jute stocks as a means of reducing the volatility of jute export prices.

Mr. Goos made the following statement:

I would like to join other speakers in commending the authorities for the largely successful implementation of the adjustment program thus far. We are particularly impressed to note that performance in such critical areas like growth, inflation, and external accounts has been more favorable than anticipated. This success is all the more heartening in view of the fact that it has been achieved in an environment of a pronounced deterioration of the terms of trade and declining prices for Bangladesh's traditional exports.

Compared with that success, developments had been less satisfactory in other key areas such as fiscal policy and public enterprise management, as well as tackling the serious difficulties in the financial sector relating to nonperforming loans. The shortcomings in these areas clearly call for special attention in the ongoing adjustment effort and it is reassuring to note that they have been given adequate emphasis in the staff report. While agreeing with the general thrust of the staff appraisal, I feel that some of the program targets set for 1986/87 could have been set at more ambitious levels. For example, it should be noted that there will be only a modest improvement in the overall budget deficit in terms of GDP compared with the rather disappointing outcome in the last fiscal year and it will considerably increase in nominal terms compared with the program targets for 1985/86. Even if the expenditures for food and grain stocks were excluded, it is questionable whether an improvement of 0.4 percent of GDP over last year's program target can be regarded as appropriate and consistent with the country's difficult overall situation. Not surprisingly, this modest performance in central government operations would be mirrored in the lack of further progress--in terms of GDP--in the reduction of the external current account deficit that, owing to the projected rate of real growth, would again imply a substantial increase in the external gap in nominal terms.

In view of these developments, I have some reservations about the assessment on page 9 of the staff paper, which states that "the stance of fiscal policy is in accord with the original (program) objectives of mobilizing additional domestic resources." Although fiscal policy is facing serious constraints that cannot be disregarded, there should be more scope for additional revenue mobilization and more economical use of available resources. This is borne out by the fact that last year's policy slippages were not altogether beyond the control of the authorities, but to a considerable extent of their own making. For example, as a result of their policy of currency appreciation, the authorities at the beginning of 1986 had eroded the basis of foreign trade-related tax revenues without compelling reasons. As to the projections for 1986, according to the staff report, current expenditures other than wages and salaries are expected to increase quite substantially in real terms as would expenditures for development projects. Such high rates of growth indicate that there might be more room for additional expenditure cuts that could be combined with a judicious reorientation of resource allocation in order to minimize the potentially adverse effects on growth.

Another largely untapped source for increasing national savings is public enterprise reform, which should be given more attention in future staff reports. Much more progress could be achieved in this sector in terms of overall efficiency through fundamental reforms that should include an open minded review of the appropriate role of government in the overall economy. The authorities' recent initiatives in this regard are welcome.

While these critical remarks about the adequacy of the adjustment effort are meant in a constructive spirit, they are prompted by the view that the authorities should take full advantage of the current relatively favorable domestic and external environment prevailing outside the jute sector to vigorously redress existing imbalances in order to create the basis for sustainable growth and greater resilience of the economy to future exogenous shocks. Seen in this perspective, the staff's assessment that there is not much scope for a further improvement in the current account appears quite pessimistic and, in my opinion, they may be giving up too early.

Despite those reservations, I can support the proposed decision. However, in doing so I would hope that the authorities will make every effort not only to attain but wherever possible to outperform the program targets, most notably with respect to the fiscal deficit, inflation, and the external resource gap. I would like to encourage the authorities to persevere in their structural reform efforts; although progress made in this area has been commendable, the staff report leaves little doubt that much remains to be done, most notably in tax reform, rehabilitation and privatization of public enterprises, strengthening the financial system, and unification of the exchange markets. There also seems to be much room for moving ahead with trade liberalization and improving the investment climate for domestic and foreign capital.

As to Mr. Sengupta's proposal to establish a buffer stock in order to assist the jute sector, I share the reservations expressed by Mr. Lankester. The jute sector seems to be faced with a long-term decline owing to increasing substitution by other materials. As such, other solutions might be more appropriate. It would be helpful if the staff commented on this proposal.

Ms. Lundsager made the following statement:

Bangladesh's performance under the stand-by arrangement has been good and all performance criteria have been met through June 1986. As noted at the meeting on the 1985 Article IV consultation with Bangladesh in December 1985, Bangladesh faces a number of difficulties and it is reassuring that the authorities have made substantial progress in their adjustment efforts. The most welcome development has been the lower inflation rate and the higher than expected growth rate due to high agricultural and industrial activity. Despite the decline in the terms of trade, these developments have led to lower imports and a reduced current account deficit. The overall balance of payments surplus has enabled a large reserve buildup, which is particularly welcome in view of Bangladesh's vulnerability to external factors.

One area in which performance has fallen somewhat short is the budget--the fiscal deficit target was exceeded in the 1985/86 fiscal year, with the revenues falling short of expectations. Given the rather low ratio of revenues to GDP, a strengthened revenue effort should be pursued and we welcome the intention of the authorities to undertake tax reform. It is noteworthy that compliance has improved with the reduction in the marginal tax rates. Expenditures were somewhat higher than expected and the authorities have taken measures to compensate for that development. One area in which progress has been made has been the improvement in Bangladesh's capacity for project aid absorption. Efficient aid utilization is a high priority if imports and investment are to be maintained and growth to be sustained.

The fiscal policy outlined for the new fiscal year appears to be oriented toward maintaining the existing capital stock through adequate budgeting for current maintenance. Following increases in administered prices, subsidies are being reduced, which is an important element of the effort to stimulate rational resource use utilization while restraining the fiscal drain on the economy. The elimination of the fertilizer subsidy is particularly welcome. Finally, it is appropriate that the wage bill be contained in 1986. It would be useful if the staff provided information on whether the authorities might be considering a general civil service reform.

Public enterprise management is an area where much work needs to be undertaken in consolidating the measures that have already been taken. Privatization might not be a simple task in a low-income country such as Bangladesh, but it would appear to be feasible to spin off some smaller scale commercial enterprises. It seems that such steps are being coordinated with the World Bank and other donors in an effort to strengthen the overall financial position of these enterprises. The staff paper's description on page 13 indicates that this process will be slow; perhaps some emphasis could be placed on accelerating the reform effort.

Significant problems remain in the monetary sector, given the continuing problem of nonperforming loans that have weakened the commercial banking sector. We share Mr. Lankester's concerns about the jute sector and its impact on the banking system. An encouraging sign has been the shift of financial assets into the commercial banking system, from which it would appear that positive real interest rates on deposits are having the desired effect.

As to the external sector, past exchange rate adjustments apparently produced the desired results--workers' remittances increased substantially, and nontraditional exports grew from virtually nothing in 1981/82 to 16 percent of imports in 1985/86. This impressive growth demonstrates to other nations the potential for the growth of exports. The staff report emphasizes maintaining competitiveness through exchange rate adjustments and urges the authorities to keep in mind their export achievement when deciding the appropriate course of action. Despite the improvement in nontraditional exports thus far, the current account will probably not strengthen much over the medium term; however, the current account may be manageable since aid inflows are expected to remain high. Nevertheless, we continue to urge early unification of the exchange markets in order to place all domestic economic decision making on the same terms. In this context, we welcome the recent transfer of additional export transactions to the secondary market.

In 1987, the debt service burden will return to a more manageable level, following some prudent advance repayments of commercial food credits this year. Caution should be exercised in the future in acquiring debt on commercial terms and we would urge that it would be restricted to projects that can be expected to generate enough foreign exchange to service the related debt.

In sum, it appears that the general thrust of the authorities' policy stance is to strengthen the productive potential of the economy. This is not an easy task in a country where private savings can be expected to grow slowly in the medium term and where the Government remains heavily dependent on foreign aid. This is why it is so important to encourage those sectors which can become competitive in world markets. I would hope that with an improved financial environment, it will be possible to attract and sustain higher levels of foreign investment. Ongoing efforts to liberalize the trade and payment system, as well as the investment regime, should encourage both domestic producers and foreign investors; additional measures might probably be required.

Finally, the authorities continue to merit Fund support of their adjustment effort, and completion of negotiations for an arrangement under the structural adjustment facility could assist in promoting additional adjustment efforts in the areas of tax reform, public enterprise management, and the banking system, which appear to be crucial for medium-term structural adjustment. As Mr. Lankester has noted, exchange rate unification and trade forms are also important. I look forward to a continuing successful adjustment effort supported by donor assistance, and support the proposed decision.

Mr. Sugita made the following statement:

The Bangladesh authorities should be commended for their successful efforts in the first year of the adjustment program. Most of the program targets in the main areas have been observed.

The real GDP growth in 1985/86 was higher than anticipated and the rate of inflation was reduced to 10 percent. The current account deficit declined to 6.6 percent, which was 0.7 percent below the program target. However, the economy remains structurally weak and the balance of payments is still vulnerable to external shocks. Export earnings finance only one third of imports and rely heavily on traditional goods, especially raw jute and jute goods. The low domestic savings rate is another concern; the national savings ratio is less than 5 percent.

Persistent efforts must be made to dissolve these problems and I welcome the continuation of adjustment efforts under the stand-by arrangement.

As a result of the authorities' efforts, the government budget deficit declined to 7.7 percent, which, however, was larger than the program target. Further reduction in the budget deficit is envisaged for 1986/87. On the expenditure side, significant growth has been made in reducing subsidies for foodgrain and fertilizers. I welcome the authorities' commitment to further reducing the foodgrain subsidy and eliminating the fertilizer subsidy in 1986/87. Given the sizable wage and salary increases in 1985/86, it is appropriate that the program does not provide further adjustments in wage rates. I note with satisfaction that the savings in these areas will allow the authorities to put more emphasis on operations in maintenance spending, which will enhance the efficiency of existing stocks.

Deviation in fiscal performance from the program target in 1985/86 highlights the need for further efforts in domestic resource mobilization. Although a number of tax measures have been taken to realize the revenue increase envisaged under the program for 1986/87, the tax system suffers from the basic weakness of low elasticity, as the staff rightly notes. Further review of the tax system and tax administration should be expedited with assistance from the Fund and the World Bank. The public enterprise sector is another area in which efforts should be made to achieve more efficiency with appropriate technical assistance from the Fund and other donors.

I can generally endorse the restrictive stance of monetary policy that is envisaged for 1986/87. The Government's commitment to a flexible interest rate policy is also welcome. However, the slow progress in improving loan recovery by the domestic banking system is a source of concern and should be addressed as soon as possible, together with the more fundamental review of the financial sector being conducted by the World Bank.

The present stagnant jute prices are expected to linger as a result of progressive substitution by synthetics, thereby adversely affecting the medium term as well as immediate prospects for the balance of payments situation. Therefore, the diversification of exports is crucial for restoring a sustainable balance of payments position over the medium term. As to export promotion, the authorities need to implement the exchange rate policy flexibly and to enhance the efficiency of resource allocation through trade and exchange liberalization.

Finally, I recognize that this program incorporates many structural policies that might provide the basis for the use of resources under the structural adjustment facility. Therefore, I look forward to hearing further comment from the staff on the progress of negotiations with the authorities on this subject in the near future. I support the proposed decision and wish the authorities well.

Mr. Hodgson made the following statement:

The authorities should be commended for the generally successful results thus far. We are pleased to note that all performance criteria under the program have been met and that the program has been implemented as planned with the exception of some slippage in fiscal policy.

Some encouraging results have already been seen: real growth of 5 percent during 1985/86 was higher than anticipated; inflation slowed by 10 percent; and the balance of payments outcome was positive, despite the significant decline in Bangladesh's terms of trade. Indeed, it is notable that export volumes during the 1985/86 program grew by about 22 percent, which is testimony to the flexible exchange rate policy and other measures taken to promote exports. However, it is apparent that stronger efforts will be needed to strengthen the tax base, improve tax administration, tighten government control over expenditure management, and tackle more strenuously the loan recovery problems of the development finance institutions.

We can broadly agree with the staff report on the policy framework for the remainder of the program. The continued weakness in the terms of trade, together with an anticipated decline in workers' remittances, make it all the more important that the authorities maintain their strong commitment to the adjustment program. Various measures to enhance revenue are planned for 1986/87, including increased duties on oil imports and adjustments in domestic excise taxes and certain fees. Although these short-term measures are welcome, we agree with the staff that the authorities need to address the overall elasticity and buoyancy of the tax system. Therefore, we support the authorities' intention to review tax policy and tax administration during the current fiscal year. We can certainly support any technical assistance the Fund might provide in this area.

On the expenditure side, we join the staff in commending the authorities for improving the administration of expenditure, including maintaining tight control of the wage bill, reducing various food subsidies, and taking measures toward the complete elimination of the fertilizer subsidy. However, it is apparent that insufficient attention has been paid to the operations of parastatals and we would urge the authorities to address this sector in a much more rigorous fashion. The UNDP project should provide valuable assistance in this sector.

We share the concern of other Directors about increasing credit to the jute sector in the face of what appears to be a long-term decline in the world demand for jute. A more comprehensive approach toward reform of the jute sector would seem warranted. While recognizing that the growth rate of credit to the public sector has declined, there still seems to be further room for tightening credit conditions for the public sector, particularly for the parastatals. However, it is understandable that the authorities would like to make some net credit available to finance increased food stocks. We urge the authorities to seriously tackle the problem of inadequate loan recovery, a solution which is essential for a properly functioning financial system.

We encourage the authorities to maintain their commitment to a flexible exchange rate policy that will permit the external sector to adjust more rapidly and encourage growth of nontraditional imports. Continued efforts should be made toward the unification of the official and secondary exchange rates; we agree with the staff that further transactions are possible and these should be shifted into the secondary market. We support the proposed decision and wish the authorities continued success under this stand-by arrangement.

Mr. Nimatallah made the following statement:

Bangladesh is well poised for more comprehensive medium-term reforms because the authorities have successfully stabilized their economy with the help of the stand-by arrangement provided by the Fund. I commend the authorities for their serious efforts to manage demand and resume economic growth. They have met all the performance criteria; therefore, I support the proposed decision.

The authorities have a challenging task before them that involves consolidating stabilization efforts, continuing structural adjustment, and sustaining growth. I believe the authorities can meet the challenge. I encourage them not to weaken their demand management resolve to consolidate their stabilization efforts, otherwise they will risk facing rising inflation once more and will miss the opportunity of a balance of payments surplus and buildup of reserves. Therefore, on the government revenue side, I hope that the authorities will improve the tax structure and tax collection. I also hope that, in the medium term, the authorities will reduce their vulnerability to external disturbances.

On the expenditure side, I encourage the authorities to contain their expenditure within available resources. This can gradually be achieved by reducing subsidies that not only burden the budget, but also distort the allocation of resources.

In order to achieve more structural adjustment and sustainable economic growth, the authorities will have to accelerate their efforts in two areas: reforming the public sector enterprises, both financial and nonfinancial; and enhancing the diversification of the export base. In this context of reforming public enterprises, it would be useful if the cost of the enterprises were streamlined and efficiency enhanced. It would be appropriate to transfer to the private sector any activities that could best be handled by that sector without harming the economic and social fabric of Bangladesh. However, in my opinion, public enterprise management is an aspect that I am most concerned about. I would suggest that the authorities enhance the training and development of the skillful management of these organizations. I would like to ask the staff to indicate to the authorities--during the structural adjustment negotiations--the possibility of establishing a large, high quality training center for managers to enable them to become autonomous in running the public sector enterprises and establishing specific objectives. Without such training, there will be a frequent turnover of managers. The economy will benefit if a well trained, autonomous body of managers is prepared to run the public sector enterprises. It would also be useful for countries like Bangladesh to emphasize training for effective management.

As to the balance of payments, it is undoubtedly true that it would be highly beneficial for Bangladesh to diversify its exports. The question is how to achieve that diversification. The authorities should be commended on their exchange rate policy. The flexibility they are maintaining will be helpful in enhancing the competitiveness of their exports. However, more effort is needed, and this will have to be combined with more appropriate medium-term policies to further enhance the efficiency and competitiveness of export industries. Among these policies would be pricing, wages, tax incentives and, above all, freer trade practices. It is very important that Bangladesh's trading partners open up their markets for Bangladeshi exports.

In order to achieve these demanding measures, the authorities would be well advised to accelerate their discussions with the staff on an arrangement under the structural adjustment facility. That arrangement should be combined with assistance provided by the World Bank in order to maximize the benefits from the combined efforts of all parties in achieving the three major goals: consolidating stabilization; continuing structural adjustment; and sustaining growth. I congratulate the authorities on their efforts and wish them well.

Mr. Rye made the following statement:

Bangladesh is a country beset by immense problems, including extreme poverty, overcrowding, and susceptibility to natural disasters. Against that background, the authorities are clearly doing a commendable job, to which the successful start in meeting the objectives of the program testifies. There seem to be two dimensions to the authorities' achievements: first, undertaking the appropriate policies, where it is encouraging to note the progress made in tightening financial policies and slowing down recent monetary expansion, as well as reducing subsidies and price controls; second, recognizing areas, mainly structural in nature, where more effort would be required and being prepared to review those areas with assistance from outside the country in resolving those problems. It is noteworthy that the authorities intend to review tax policies and administration, to tackle the weaknesses of the nonfinancial public sector--with the help of the World Bank and other donors--and to review the financial sector to ameliorate the existing weaknesses and strengthen the supervisory role of the Bangladesh Bank. I would encourage the authorities to pursue these and other necessary structural reforms with vigor.

Bangladesh will need substantial donor support for a long period of time. It will also need ready access to external markets if its level of self-sufficiency is to be increased. In particular, the barriers against nontraditional exports must be lowered. Domestic encouragement cannot achieve much in the face of unwelcoming external markets.

In sum, the authorities deserve commendation for their approach under the program thus far. I agree with the staff's conclusion that it would be necessary to continue to monitor developments closely and take timely action as warranted to ensure the achievement of program targets. This chair wishes the authorities well in its endeavors. I am happy to support the proposed decision.

Mr. Salehkhou made the following statement:

Considerable progress has been achieved by Bangladesh under the current stand-by arrangement with the Fund. Except for a lower reduction in the government budget deficit than envisaged under the program, the performance in all other areas was largely satisfactory and in many instances exceeded the targets set under the stand-by arrangement. To a large extent, such performance reflects the favorable impact of bumper crops and the surprisingly strong recovery in workers' remittances. However, the major contribution appears to be the determined implementation of the adjustment program and the restoration of confidence in the economy.

Improved economic performance in 1985/86 was most pronounced in the external sector as Bangladesh, despite a further deterioration in its terms of trade, achieved a commendable turnaround from an overall balance of payments deficit of $59 million in the previous year to a surplus of $78 million, which was substantially higher than the amount projected under the program. The year was also marked by a stronger real GDP growth, and notwithstanding the impact on consumer prices of the devaluation of the taka as well as adjustments in administered prices, inflation was contained below the programmed level. The implementation of restrained financial policies also permitted a significant deceleration of monetary expansion and a small reduction in the fiscal deficit. The authorities have not only reversed the real effective appreciation of the taka and restored export competitiveness to below the 1983 base level, but have also increased the scope of the secondary exchange market and further narrowed its premium over the official exchange rate.

Although Bangladesh's financial program is clearly on track and all the quantitative performance criteria have been met, continued adjustment efforts are obviously warranted in order to consolidate the progress achieved during 1985/86 and to correct the imbalanced structure of the balance of payments, which should in the current year face a certain bunching of external debt repayments, a probable decline in workers' remittances, and continued unfavorable prices for Bangladesh's traditional exports. Although the balance of payments generally stands to benefit from lower international oil prices, the staff notes that this benefit is expected to be offset by the impact of lower workers' remittances from oil producing countries. Furthermore, stronger efforts are needed in the fiscal area to avoid the slippages of 1985/86 and to reduce the vulnerability of government revenues to developments in the external sector. It should be noted that only limited progress has been achieved in the introduction of structural reforms, including those related to fiscal policy, public enterprises, and the banking system.

It is encouraging to note that the financial program for 1986/87 is concerned with the correction of most of the economic imbalances and that many of the necessary structural reforms are being addressed with assistance from the World Bank and the Asian Development Bank. The measures implemented in the fiscal area are particularly welcome, including the review of tax policy and administration, the setting of the investment program within the limits of expected domestic and foreign financing, the reduction or elimination of certain subsidies, and the undertaking to strictly limiting recourse to the domestic banking system.

It is appropriate that the program also concentrate on further strengthening monetary policy. Indeed, although significant progress has been made in reducing monetary expansion and containing inflationary pressures, problems do remain with respect to financial intermediation and the sharp deceleration in the growth of credit to the private sector. Although this deceleration does to some extent reflect the difficulties faced by the banking system in recovering loans, credit to the private sector has been affected by the continuation of high interest rates in the face of the moderation of inflationary expectations. While the authorities have now reduced selected interest rates to reflect lower inflation, there appears to be an insufficient sense of urgency in addressing the crucial problem of loan recoveries; this could dangerously affect confidence in the banking system. I support the proposed decision.

The staff representative from the Asian Department said that the shortfall in fiscal performance had not been entirely beyond the control of the authorities. Additional effort would be needed to increase domestic taxes, in particular excise taxes. There had been a shortfall in domestic taxes of about Tk 1.4 billion, the factors responsible for which had been quite complex and related to the interrelationship among the various taxpayers within the system. The authorities were well aware of the problems and had accorded the area priority, and it was expected that it would be carefully reviewed by the technical mission from the Fund and the World Bank.

The shortfall in the nominal taka value of imports did have an impact on the nominal level of revenues, the staff representative continued. Although the exchange rate could have depreciated further, it should be noted that the rate had depreciated well below the reference level--in early 1986, it had leveled out at about 6-7 percent below the base level in the first quarter of 1983. That development, together with the impact of depreciation on price movements within the country, convinced the authorities not to undertake further depreciation.

The fiscal program for 1986/87 envisaged a large reduction in current expenditures, the staff representative noted. The anticipated rate of growth in current expenditures would be about 11.6 percent in 1986/87 compared with 23 percent in 1985/86. Since most of the increase in current expenditures would be for operations and maintenance, other categories of expenditures had in fact been reduced. Expenditures had been further reduced in subsidies on food and fertilizers. Adjustments in other categories of expenditures in the Annual Development Plan were related not as much to the willingness of the authorities to reduce or contain the size of expenditures, but to the availability of resources. The size of the Annual Development Plan was determined by the flow of foreign resources and the current surplus; it did appear that available resources would support a 15-16 percent increase in development expenditures.

In 1986/87, there would be an estimated Tk 5 billion additional revenue effort, equivalent to about 0.8 percent of GDP, which would push the revenue to GDP ratio from 9-9.5 percent, the staff representative remarked. In the circumstances, that would represent a notable effort by the authorities. The Government intended to raise the revenue to GDP ratio to about 10 percent over the course of the Third Five-Year Plan. The reform of the tax system should facilitate that effort; in the short term, the new revenue package would enable the authorities to make substantial progress toward that objective. There would be no general salary increase in 1986/87, and the Government would continue to reduce the size of the civil service through a freeze on hiring in most sectors.

The Government faced the dilemma of balancing social objectives with economic efficiency; however, it was improving efficiency through more effective management, a better information system, more autonomy to public enterprises in the management of their affairs, and in the determination of prices, the staff representative continued. The new industrial policy announced in July 1986 had made a significant contribution to granting further autonomy and increasing privatization. The Government had reserved about seven areas for the public sector relating to communication and heavy industries, while opening up the rest of the industrial sector to the private sector. It has also decided to convert many sector industries into limited corporations with the intention of selling off up to 49 percent of their shares in the local exchange market. The Government had invited foreign portfolios as well as direct investment and had made provisions for encouraging Bangladeshis working abroad to participate and buy shares in those enterprises. With such measures now on the agenda, more substantial progress was anticipated.

As to the management of public enterprises, the Government was considering offering management contracts for certain enterprises in the near future, the staff representative said. However, the sector was large and complicated, and, therefore, progress would not be very rapid. However, the authorities were committed to undertaking management reforms and were in continuous consultation with the World Bank and other donors to improve the system.

Extending credit to jute industries was essential given the critical importance of the jute sector in Bangladesh, the staff representative remarked. A large portion of the population was engaged in jute production and a significant proportion of the labor force was involved in jute operations. Although it had recognized that there was a secular trend in the price of jute, the Government was uncertain about the direction of future policy. In 1985, jute production was expected to have been about 5 billion bales; the outturn had been 7.6 billion bales. At the beginning of 1986, 4.2 billion bales of jute had been produced and a new season was expected to produce about 5 billion bales. Thus, the Government was faced with the dilemma of trying to absorb the increase in jute production. At the same time, the jute industry had found it difficult to dispose of jute stock, and the demand for credit was rising. Thus, the extension of credit had been involuntary because jute prices had not risen as expected and jute industries had been unable to repay the banking system, which did not relieve the pressure on the authorities to pursue their tight monetary stance. In consultation with the World Bank, the authorities were making efforts to improve the loan recovery rate and to set up a high level commission to establish rules and procedures for improving loan recoveries in the economy. The authorities were examining the possibility of establishing a jute buffer stock to ensure a minimum price for producers. The Bangladesh Jute Corporation--which was government-owned--was holding large jute stocks.

The current account deficit in Bangladesh was influenced by several factors, notably the flow of foreign remittances and the level of export earnings, the staff representative observed. The prospects for those factors did not appear to be very promising in the immediate future. The only way to improve the current account would be to reduce imports. However, the level of imports was basically determined by the availability of foreign aid and the ability of the country to absorb foreign assistance. The staff believed that there would not be much room for improvement in the current account deficit in 1986/87 because export prospects did not appear very bright and workers' remittances did not appear to be showing signs of increase.

Negotiations were continuing on the use of Fund resources under the structural adjustment facility, the staff representative added. A draft paper that had been submitted to the authorities was being revised in collaboration with the World Bank and the staff intended to reach a final agreement on the draft during the Annual Meeting.

The staff representative from the Exchange and Trade Relations Department said that the desirability of an international buffer stock for jute would depend on an assessment of the general status of the jute industry. Currently, the jute industry appeared to be declining in the face of competition by close substitutes, such as synthetic fibers. Although the industry was important to Bangladesh, it should probably be encouraged to shrink, which would be possible only if Bangladesh's entire export base was broadened. Therefore, it was for consideration whether the external financial resources necessary to establish a buffer stock should be committed to a price stabilization arrangement or, alternatively, used to diversify the export base. As to the management of an international buffer stock, in view of the long-term trend of declinig prices for jute products, it would be very difficult for producers and consumers to reach agreement on price intervention rules. In particular, the industry faced the great difficulty of the availability of very close substitutes, the prices of which had moved with the real price of petroleum, thereby raising the possibility of volatility and a very large degree of price variance among substitutes. Thus, the management of price intervention rules would be very difficult.

Mr. Nimatallah said that some of the countries that had been involved in negotiations with the Fund on the structural adjustment arrangements had faced problems in coordinating their discussions with the Fund and the World Bank. Such medium-term structural adjustment programs were difficult to put together because of the involvement of various organizations. He wondered if Bangladesh was facing such a problem.

Several countries were suffering from the problem of public enterprise management, Mr. Nimatallah continued. The issue involved not only the quality of managers, but also the process of decision making and the degree of autonomy in managing funds. The idea of hiring management consultants from outside the country was welcome. He wondered about the nationality of the managers being hired for Bangladesh. He also wondered whether it might be possible for countries like Bangladesh to establish management corporations with which the Government would have contracts to manage public enterprises.

The staff representative from the Asian Department said that a management team from Belgium had been brought in to manage Bangladesh's machine tool factory, which demonstrated that management contracts could involve foreign experts.

As to measures to improve the public enterprise management situation, the authorities' most recent position was described in the industrial policy statement of 1986, which stated that public enterprises would be converted into public limited companies and public sector corporations into holding companies; the shareholdings that would be divested would amount to 49 percent, the staff representative continued. The authorities intended to improve the management of public sector enterprises and to divest as many enterprises as possible, although certain organizations would be reserved for the public sector because of their importance on national security grounds or because private investment was not forthcoming.

Bangladesh did not appear to be facing a problem in negotiating an arrangement under the structural adjustment facility, the staff representative remarked. The authorities had identified the major areas for economic reform and broadly determined the framework of policies that would be implemented over the coming years. Thus, there was a clear picture about areas that would require structural reform: taxation; the financial sector; trade liberalization; and exchange rate policy. The reason for the delay in reaching an agreement on the program was that the authorities were trying to ensure that the policy framework paper would be consistent with the Third Five-Year Plan announced about six months ago. Thus, the authorities had decided that further consideration of the paper was warranted. However, now that the authorities had communicated their reaction, the staff was preparing the draft paper that would be finalized at the Annual Meeting.

The Acting Chairman said that any instances where there had been problems in negotiations on structural adjustment arrangements for individual countries should be brought to the attention of management.

Mr. Sengupta said that Mr. Nimatallah's comments on public enterprise management were extremely helpful. His authorities were very concerned about the efficiency of public sector enterprises. They had taken a number of measures to attempt to resolve management problems, including the industrial policy resolution he had referred to in his opening statement, measures to facilitate the privatization of enterprises by improving management through management contracts, and also other structural reorganization measures. The establishment of public management training institutions would require financial and nonfinancial assistance from different sources.

The negotiations on an arrangement under the structural adjustment facility were proceeding smoothly and an agreement was expected soon, Mr. Sengupta noted.

An assessment of the condition of the jute industry would require careful examination, Mr. Sengupta commented. Although he had not expected the staff to provide a detailed response, he had raised the issue because it was more complicated than it seemed. It was not clear whether the jute industry was a decaying industry. The situation had changed considerably after the oil price increase because the prices of jute substitutes had increased. The introduction of a number of technological processes had helped to reduce the unit cost of production of jute goods. Thus, even the long-term trend of the prices of jute goods did not show significant variance. There were different jute goods for which substitutes existed--hessian bags, carpet backing, wool hangings, carpets, and so on. The World Bank had prepared several studies on jute substitutes, in which one of the issues that had been raised was the question of the long-term trend of jute goods and productivity in the jute industry. Another issue was that of fluctuation around the long-term trends that created special problems for countries which had concentrated most of their industrial exports in the jute sector. The fluctuation of jute prices was the issue that most concerned his authorities.

The buffer stock concept was not new, having been talked about for the past 10-12 years, Mr. Sengupta remarked. The establishment of the buffer stock did involve problems of management; however, those problems were not intractable. The problems related basically to the size of the buffer stock that would be required to stabilize the prices of jute goods, and the prices of raw jute goods derived from the prices of the finished goods. Nevertheless, it had been quite clearly established in the numerous discussions on the buffer stock concept that the effort for stabilizing jute prices would have to be undertaken internationally. For Bangladesh, a buffer stock would be particularly important, not only because a substantial number of farmers were involved in raw jute production and cultivation, but because the jute industry was the major industry in the country. Besides having an immediate impact on inventory management, the fluctuations in jute goods prices also had implications for credit and financing because the developments would be spread over a period of time.

As to the current account deficit, the staff report stated that the overall budget deficit as a percentage of GDP was 7.2 percent for the 1986/87 program, which was 0.5 percent less than that of 1985/86, Mr. Sengupta observed. However, the effect of the improvement was much more than indicated if expenditures for foodgrain stocking were excluded, which would bring the deficit down to 6.9 percent. Foodgrain stocking was an exogenous factor in a country like Bangladesh, where a food stocking policy had to be maintained if there were overproduction in some years to offset any adverse effects over the long term. Thus, the effort was not as unimpressive as might appear at first sight. The reason why the current account deficit could not be brought below 6.6 percent related to export performance. Bangladesh's export performance had been quite impressive, and it was one of the few countries that had made tremendous progress in terms of increasing exports in volume terms. There had been a 22 percent increase in 1985 and a further 9 percent increase in volume terms in 1986. However, the prices of jute exports--over which Bangladesh had very little control--had been such that the total value of exports had not increased very much. Bangladesh was also facing protectionist pressures from developed countries, particularly in its dynamic exports of garments. The ability to increase exports, at least in the short run over the next few years, would be dependent upon the international environment. Another major bottleneck was the potential for diversifying the export sector. Given that situation, any attempt to reduce the current account deficit below the present level would mean reducing imports substantially, which would have an adverse effect on the growth of Bangladesh and its ability to absorb foreign aid. Indeed, Bangladesh's absorptive capacity was very large; if foreign aid was increased, then Bangladesh would be able to increase the import of capital goods, which would have an immediate impact on the country's growth.

The Executive Board then took the following decision:

1. Bangladesh has consulted with the Fund in accordance with paragraph 4(c) of the stand-by arrangement for Bangladesh (EBS/85/251, Sup. 1, 12/4/85) and paragraph 26 of the letter dated November 5, 1985 from the Advisor for Finance of Bangladesh, in order to assess performance under the program supported by the arrangement and to set performance criteria for the remaining period of the arrangement.

2. The letter dated July 30, 1986 from the Advisor for Finance shall be attached to the stand-by arrangement and the letter dated November 5, 1985 shall be read as supplemented and modified by the letter of July 30, 1986.

3. Accordingly,

(a) the limits on net domestic assets of the banking system and net credit to the Central Government from the banking system referred to in paragraph 4(a) of the arrangement will be as set forth in Table 2 of the letter of July 30, 1986; and

(b) the limits on contracting of new public or publicly guaranteed external loans with maturities of one to twelve years and one to five years, and on the outstanding stocks of external public debt and of external liabilities of Bangladesh Bank, both of less than one-year maturity, referred to in paragraph 4(b) of the arrangement, will be as set forth in Table 1 of the letter of July 30, 1986.

Decision No. 8376-(86/141), adopted
August 29, 1986

2. GREECE - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with Greece (SM/86/186, 7/31/86). They also had before them a background paper on recent economic developments in Greece (SM/86/203, 8/15/86; Cor. 1, 8/12/86; Sup. 1, 8/18/86; and Sup. 2, 8/27/86).

Mr. Kyriazidis made the following statement:

I wish to express my authorities' high regard for the consultation mission's competence and objectivity which, together with their courteous frankness, contributed decisively to the development of the consultations into an extremely fruitful dialogue. My authorities also highly appreciated the high quality and objectivity of the mission's report. This does not mean, of course, that they agree with everything that is said in the report, nor indeed that they do not feel that in some respects it is perhaps severe. But these are matters of judgment and any divergences of opinion that may persist, besides being inevitable in any such exercise, do not detract in the opinion of my authorities from the value of the report's analysis and the correctness of its general thrust. I do not intend, therefore, to dwell on these divergences, particularly since most of the reservations expressed by the staff to which we might have taken exception are not unreasonable given the information available at the time of the consultations. Indeed, I believe they have to a large extent been overtaken by the additional information that has become available since the report was written and which is contained in the staff's supplementary note. My remarks will, therefore, be directed toward assisting the Board in arriving at as accurate an assessment as possible of the Government's current policies and the progress achieved in their implementation.

As you all know, not least from the staff report, the most important development in 1985 was the introduction of a stabilization program against the background of rapidly worsening domestic and external imbalances in the economy which constituted a serious deviation from the Government's intended course and required immediate corrective action. The specific circumstances are outlined in sufficient detail in the staff's report to make any further comment unnecessary.

Let me only briefly repeat however what the main elements of the program are. The immediate targets are:

first, a rapid deceleration of inflation from an annualized rate of 33.9 percent in the second half of 1985 to 16 percent by December 1986 and to less than 10 percent by the end of 1987, excluding the effect of the introduction of VAT; and

second, the restoration of the competitiveness of the economy and the reduction of the current account deficit from an estimated \$2.8 billion in 1985 to \$1.7 billion in 1986, \$1.3 billion in 1987 and \$1.0 billion in 1988, a level consistent with the stabilization of the external debt.

These targets are to be achieved through:

(a) a statutory incomes policy spread over two years implying a substantial decline in real wages and a rapid deceleration of labor costs;

(b) an initial devaluation of the drachma by 15 percent, followed by an exchange rate policy aimed at maintaining the competitive gains thereby achieved;

(c) a reduction of the public sector borrowing requirement (PSBR) to 11.0 percent of GDP from the estimated level of 16.0 percent in 1985; and

(d) a substantial deceleration in the growth of monetary aggregates; more specifically, the targets were a deceleration of growth in M3 to 19.9 percent compared with 27.3 percent in 1985 and of credit expansion to the private sector to 17.7 percent from 20 percent in 1985.

Although actual developments in 1985 deviated significantly from the assumptions on which the program was based, the Government still adheres to the targets originally set and had adjusted its stance to this effect. More particularly, the PSBR in 1985 turned out to be more than 2 percentage points higher than assumed (i.e., 18.2 percent) and the current account deficit rose by the end of the year to $3,300 million (instead of $2,800 million) or 10 percent of GDP. Adherence to the targets originally set, therefore, implies for the PSBR ratio to GDP, a reduction by over 7 percentage points instead of 5 percentage points, and for the current account deficit in the balance of payments, a reduction by $1.600 million instead of $1,100 million (which is more than 5 percentage points of GDP.)

No doubt the adherence to these strict objectives has been facilitated by the decline in oil prices that, besides leading to a significant reduction in total imports, allowed the Government to raise a substantial amount of additional revenue through higher taxation of oil products. However, the lags in response that are unavoidable in any major shift in economic policy have also proved to be more persistent than anticipated mostly due to excess liquidity which gave rise to perverse speculative reactions chiefly reflected in an upsurge in total demand and non-oil imports.

It is in the light of these considerations that economic developments in 1986 and the adequacy of the Government's policy have to be assessed.

Developments in GDP and domestic demand

The rate of growth of GDP in real terms in the last quarter of 1985 had accelerated from an estimated average rate of 1.2 percent during the first three quarters of 1985 to 4 percent above the corresponding period of 1984.

GDP growth is estimated to have been maintained throughout the first half of 1986, though at a lower rate than in the last quarter of 1985 (around 3 percent), under the impetus of vigorous domestic demand and increased activity in housing construction. These are carryover effects from the previous year supported by shaky confidence immediately after the devaluation and excess liquidity. In particular, the demand for housing appears to have been stimulated by the shortage that had developed as a result of the low level of construction in recent years, the liberalization of rent control, and the rapid expansion of mortgage credit in the early months of the year.

However, by midyear the pace of growth in consumer demand appears to have receded, as indicated by the decline in the volume of retail sales in recent months. This appears to reflect the restoration of normal conditions of confidence as well as the measures taken in May and June to restrain liquidity including the containment of the expansion of mortgage credit. As a result of these developments, the spillover of growth in demand into imports which has been clearly evident in the first few months of the year is confidently expected to be effectively reabsorbed in the coming months.

Prices and incomes

The most significant progress has been made on the inflation front. In fact, developments are somewhat more favorable than the staff's estimates. The rate of increase in the consumer price index since December 1985 had decelerated to about 8 percent by August compared with 33.9 percent in the last half of 1985, which when annualized implies a rate of inflation clearly lower than the target of 16 percent, most probably about 15 percent. It is significant to note that this deceleration in the rate of inflation owes nothing to the decline in oil prices which has not been passed on to the end-users and should be attributed mainly to the statutory incomes policy that was introduced in October. On the basis of this policy, the cumulative indexation adjustment of wages amounted to 5.8 percent for the first eight months compared with the adjustment of nearly 22 percent that would have been applicable under the previous system. The Government announced yesterday that for the last four months of the year the indexation adjustment would be limited to 4.7 percent, although the anticipated rise in the CPI is expected to be about 5.5 percent. This makes the cumulative overall adjustment for the year 10.5 percent. This adjustment will further be dampened because it is fully applicable only to the first Dr 50,000--approximately $370--of wage income. These figures imply a significant reduction in real wages even if the unavoidable wage drift is taken into account. The significant deceleration of costs achieved in this fashion appear to have been fully reflected in prices since the deceleration of inflation has been achieved in spite of the lifting of price controls at a rate much faster than originally envisaged. Indeed, as of now, only prices of public utilities and certain essential goods like bread, remain under control while rent controls will be abolished by the end of the year. Thus, it would seem that the possible inflationary effect of the lifting of price controls have already been absorbed without any deviation from the targeted deceleration of inflation. For 1987, the target continues to be a reduction in the rate of inflation to 10 percent by the middle of the year and significantly less by the end, excluding the effect of the introduction of the value-added tax (VAT) which on a revenue neutral basis is expected to add directly and indirectly about 3 percent to the CPI by the end of the year.

Fiscal and monetary policies

The policy of fiscal restraint has been firmly maintained. Despite some deviation at the beginning of the year, mostly due to a larger than expected carryover of expenditures from the previous year, the figures for the PSBR both on an accrual and a cash basis up to July are converging toward the targets set as noted in the supplementary note of the staff. It is the firm intention of the Government to maintain this stance throughout the year and to ensure a significant further reduction of the PSBR in 1987. It is, I think, indicative of the Government's determination in this respect that whether the original target was a reduction of the PSBR ratio to GDP by 8 percentage points over the two-year period of the program, policies have been adjusted so as to achieve a 7 percent reduction in the first year and an overall reduction over the two years, appreciably larger than originally considered as practical.

The rest of the public sector is also moving in a way consistent with the objectives set. The good performance of public enterprises, whose operational deficits had already been eliminated by the beginning of the year, is being enhanced to the tune of 1/3 of 1 percent of GDP by the additional revenue expected during the rest of the year from the recent 15 percent increase in public utility rates. The performance of public enterprises more than compensated for the less satisfactory development of their public entity finances, mostly social insurance funds. With regard to this last problem which has proved somewhat intractable, the Government is committed to introduce specific measures within the framework of next year's budget designed to place the finances of the public entities concerned on a permanently sound basis.

Monetary aggregates have also been brought into line despite the deviations during the first quarter of the year, as noted in the staff report. The measures taken by the Bank of Greece in June to reduce bank liquidity, combined with the containment of mortgage lending and consumer credits, the upward adjustment of some preferential interest rates, and the reduction in the interest rate rebate on exports in addition to the drastic decline in the public sector borrowing requirement on a cash basis (by 16 percent below the level of the corresponding period of last year) have firmly set the growth of monetary aggregates on a declining trend that if continued throughout the rest of the year as expected, is likely to lead to growth rates, for both credit to the private sector and M3, significantly lower than the initial targets.

In view of these developments and the deceleration of the rate of inflation, the Government has not felt that it should proceed to a general increase in interest rates. Although the authorities are very sensitive to the concern and arguments of the staff on this subject, they feel that a rise in the maximum effective lending rate of 22.5 percent to 24 percent--including bank commissions--which is applicable to the bulk of commercial bank loans and, as of June, to the bulk of housing loans as well, would not be justified since it is significantly positive in real terms, given the present and prospective rate of inflation, and might undermine the process of improvement of the profitability of the private sector, which is an essential prerequisite for the desired revival of private investment. In the circumstances, they have opted for the continuation of present policy which consists of a gradual upward adjustment of preferential interest rates and the reduction or abolition of interest rate subsidies. On the deposit side, however, it was felt that there was no need for immediate action given again the fact that nominal interest rates are close to or above the current and prospective rate of inflation and that the effective yield of deposits is considerably higher than nominal interest rates indicate, as interest income is tax exempt. In any event, the Government is studying the problem of interest rates in conjunction with a major structural reform of the credit system with a view to arriving at a deregulated, market-oriented banking system operating in parallel with a nonbank money market offering a wide choice of financial instruments and ensuring the progressive demonetization of public borrowing. These reforms are expected to be announced by the end of the year.

The balance of payments

The deficit on current account has indeed been significantly reduced from 14 percent of GDP in the first half of 1985 to 8.7 percent in the first half of 1986. More recent figures from the movement of the reserves of the Bank of Greece indicate that for the first time in a number of years, a significant surplus in the current account has been realized in July and August. These developments provide a sufficiently firm indication that the reduction of the deficit to $1,700 million or 4.4 percent of GDP as targeted for the year, is attainable. On the whole, this result must be considered satisfactory. Furthermore, it implies a reduction in the market borrowing requirement allowing the authorities sufficient room for operations designed to improve the maturity structure of the foreign debt.

There are, however, weaknesses behind these overall encouraging figures, the significance of which is recognized by the authorities. It is important to determine more precisely the nature and extent of the weaknesses. They consist mainly of the apparent persistence of a strong demand for non-oil imports and the equally apparent sluggishness in merchandise exports during the first half of the year. It would appear that speculative reactions and shaky confidence conditions supported by excessive liquidity led to an increase in demand with a serious spillover on imports during most of the first half of the year. The trend does seem to have abated by midyear. The volume index of non-oil imports on a customs basis shows a distinct deceleration over the course of the first half of 1986, and for the period as a whole, it stands at 1.4 percent above the corresponding figure for 1985. Furthermore, the decline in the volume of retail sales in May and June provides a strong indication that the trend in non-oil imports may be reversed in the second half of the year. However, the Government, although hopeful, is not complacent and its declared intention is, if necessary, to take whatever additional measures are required in the fiscal and monetary fronts to bring overall demand into line.

The slow response of exports, more particularly of goods, is also a relatively weak element in the picture during the first half of 1986. Three factors mainly account for this. First, the stagnation of trade in the major markets for Greek exports due to the weak growth performance of the European economy during the first half of the year; second, the decline in imports of petroleum exporting countries in the Middle East which had developed in recent years into major markets for Greek exports of goods and services--the decline in oil prices has also led to a loss of some $200 million in the first half of 1986 through the reduction in the value of exports of oil products; and third, a significant loss in non-oil terms of trade which has more than offset the increase in the volume of exports. Indeed, the indices just released by the National Statistical Service of Greece show for the first half of the year a volume increase in non-oil exports of 8.9 percent over the corresponding period of 1985 accompanied by an 11.4 percent decline in the terms of trade. The continuing decline in the terms of trade appears to a large extent to reflect the lags and J-curve effects of the October 1985 devaluation which it is hoped will be reabsorbed in the coming months. Prospects will become, of course, more favorable if growth accelerates in the industrial countries, particularly in Europe both as regards the volume of exports and the stabilization of the terms of trade. Finally, as regards services, the steep decline in the number of American tourists visiting Europe this year has significantly affected the growth of foreign exchange earnings from this source.

On the basis of the above, my authorities are convinced that the stabilization program is on course and its targets are likely to be attained in 1986. However, I can understand that there may be doubts--not entirely without reason--about the solidity of the gains achieved. I cannot fully dispel whatever doubts may remain. What I can assure the Executive Board is that the Government adheres firmly not only to the targets set for 1986 which already seem highly likely to be achieved but also to the targets set for 1987, namely the further deceleration of the inflation rate to under 10 percent in 1987--excluding the effect of the introduction of the VAT--and the further reduction of the current account deficit in the balance of payments to $1,300 million which implies a further decline in its ratio to GDP perhaps to 2.0-2.5 percent, a figure consistent with the objectives of stabilization of the external debt and the resumption of a satisfactory rate of growth. It is on the basis of these two basic targets, that the specific policy objectives in the fiscal and monetary sectors are to be set in the near future in conjunction with the preparation of the budget for next year which has to be laid before Parliament in November.

Furthermore, the Government is as firmly committed to maintaining in 1987 the strict enforcement of the incomes policy introduced last October as it is to prevent any deterioration in competitiveness through an appropriately flexible exchange rate policy. The authorities are aware of the fact that no major contribution to the further deceleration of inflation can be expected from the incomes policy, essential though strict adherence to this policy may be to the success of disinflation. Therefore, the major thrust in 1987 will have to come from a proper combination of fiscal policy aiming at the further reduction of the PSBR in relation to GDP combined with appropriate monetary and credit policies and some further important structural adjustments designed to increase the flexibility of the economy, the effectiveness of the instruments of monetary policy, and the restoration of financial balance to the social security funds.

Another important development expected to be completed before the end of the year is the financial restructuring or liquidation of ailing firms. It is the Government's declared intention to proceed to the financial restructuring and rehabilitation only of those firms that are viable. All others in effect, about half of the total number, are to be put into liquidation by the end of the year. The solution of this problem on the above lines will remove an important element of rigidity in the banking system and will constitute a major step toward the restructuring of the manufacturing sector.

Mr. Salehkhou made the following statement:

Since the last Article IV consultation, the Greek economy has made significant progress under the comprehensive adjustment program implemented by the authorities. In contrast to the deteriorating trend and the structural imbalances in the economy after the first quarter of 1985--about which the Executive Board had expressed concern in 1985--the stabilization effort undertaken toward the end of that year and in the first half of 1986 confirms the direction of the shift made by the authorities toward the reduction of the current account deficit, the containment of inflation and the fiscal deficit, as well as the improvement of the competitiveness of the economy.

The second half of 1985 continued to feel the effects of the authorities' earlier lax financial policy, which had led to an increase in the public sector borrowing requirement (PSBR) in relation to GNP in contrast to the original budget, which had planned to reduce the deficit by 2 percentage points through a more effective containment of expenditures and an improvement in tax collection. Likewise, the budgetary overruns had led to an increase in domestic credit and with the buildup of inflationary pressures, domestic demand had contributed further to the deterioration of the external account.

In the face of those adverse developments, the authorities had undertaken the introduction of comprehensive measures to strengthen the competitiveness of the economy by modifying its dependence on the indexation mechanism, implementing cuts in the remaining budgetary appropriations for the year, and tightening bank liquidity. Conceived as part of a package to restore the balance of payments equilibrium in 1986/87, those measures also aimed at narrowing the inflation differential between Greece and its trading partners. In the implementation of this program, the authorities have applied firm action on the income side of the policy to reduce the growth of labor cost. At the same time, fiscal and monetary policies have been strengthened and the exchange rate has been used to consolidate the advantages gained from the devaluation.

The authorities' new labor policy will enhance the profitability of enterprises, thereby leading to differentiation of wage increases on the basis of productivity. The profitability of the enterprises would also be enhanced by the liberalization of price controls. In the second half of 1985, substantial increases had been made in administered prices and charges for public services. Those measures, along with fiscal and financial incentives, had also been intended to promote productive investment and to encourage economic recovery. Efforts are being made to promote foreign investment, and the recent liberalization of capital movement for non-Greek European Community (EC) residents is likely to reinforce the inflow of capital in 1986. A major reform is also taking place in the public enterprise sector, and plans are under way to rehabilitate some of these enterprises, while it seems likely that several enterprises will have to be liquidated on account of lack of agreement with the main creditors for financial restructuring.

As to fiscal policy, the authorities expect to improve public finances, and aim at reducing in 1986 the deficit of the PSBR by 4 percentage points, from the equivalent of 16 percent of GNP in 1985. Revenue increases are expected to be generated from various sources, including the introduction of a special tax on nonlabor income and petroleum products, together with an improvement in tax collection. At the same time, government expenditures are planned to decrease because of reductions in subsidies and grants, as well as a marked slowdown in the increase in wages and salaries. In the first half of 1986, expenditure growth was negative in real terms, while the revenues of public enterprises improved on account of price increases and lower investment outlays. The authorities are aware that fiscal policy needs to be reinforced by an appropriate monetary policy. Although it could be said that monetary policy had played a minor role in the past owing to a rigid interest rate policy, the improvement brought about in the structure of credit control and the simplification of interest rates is a clear indication of the authorities' determination to resort to a more active monetary policy. The limitation set on government financing by the central bank is indicative of this new commitment.

In 1986, monetary policy is aimed at reducing the rate of inflation, promoting GNP growth, and restoring the equilibrium of the balance of payments by a deceleration in the growth of the PSBR and its financing from new bank sources, mainly through the issuance of government securities. However, data for the first quarter of 1986 indicate the need for further corrective measures at the level of monetary aggregates owing to the expansion of credit to the Government and the private sector at a rate higher than had been projected. In May 1986, the authorities took the necessary steps to tighten consumer credit and raise the rate of interest on medium- and long-term loans. Moreover, in aiming monetary measures at the adjustment of the balance of payments position, the authorities believe that the real exchange rate must move gradually to a level which would offset the differential in unit labor cost vis-à-vis Greece's trading partners. The integration of the Greek economy into the EC entails a gradual elimination of import tariffs and increases the need for ways to maintain the competitiveness of its exports. The export subsidy system is to be dismantled when the value-added tax is introduced. Given the need to stabilize the current account, exports will have to play an important role in the years ahead, particularly because of the implementation of the fiscal and monetary adjustment measures and the reform of public enterprises.

The structure of Greece's external debt appears to be manageable, although total debt remains high at 45 percent of GDP. The authorities are planning to reduce the level by 1988. For the remainder of 1986, the authorities intend to pursue a firm policy of demand management to improve the external balance. Further improvement will come from a lower oil import bill, lower interest rates, and sizable transfers from the EC. However, care must be taken to guard against slippages in demand management resulting from weak implementation of financial policy. Despite a less favorable trend in the balance of payments situation for the first half of 1986, official reserves are above the level of end-1985. It is expected that the full impact of the measures that have been implemented will be felt in 1987, particularly in the control of inflation and the improvement of the balance of payments position through a sizable reduction in the non-oil current account deficit.

Although much has been done in the area of financial control, the authorities still need to demonstrate the lasting nature of the adjustment program that has been undertaken in order to gain the confidence of the productive sector of the economy. In conclusion, I wish to support the proposed decision.

Mr. Templeman made the following statement:

In 1985, we expressed considerable concern about the performance and outlook for the Greek economy. Indeed, actual performance in 1985 with respect to growth, inflation, and the balance of payments situation had turned out to be less favorable than in 1984. More recently, there has been an encouraging shift in policy and in prospects for the economy. Nonetheless, given the favorable impact of lower oil prices, lower interest rates, and stronger European growth, we had hoped to see stronger action than has been taken. In addition, the freedom of pricing signals with respect to labor, capital, goods, and foreign exchange, remains circumscribed by government intervention, and there are important structural problems in the labor and financial markets, the industrial sector, and the fiscal accounts.

New economic targets have been set for 1986 and 1987 that aim at bringing down the rate of inflation and the size of the external imbalance and some important specific actions have been taken, notably the devaluation in October 1985 and the modification of wage indexation. However, it is not yet clear that these targets are ambitious enough and we continue to have doubts that the shift in the economic policy stance represents a fundamental change from rather heavy involvement by the Government in the operation of the economy.

It seems clear that if Greece is to adjust to the challenge of EC membership and to compete successfully with the industrial countries--and with some of the more advanced developing countries--there will be a need for a freer and more predictable environment in the country. The 32 percent decline in private business investment in 1980-84 and the 10 percent fall in investment in machinery and equipment in 1985 testify to the reluctance in recent years of private business--from which a major part of future investment and growth must come--to commit its resources. This is not surprising given the existence of price controls, rapid increases in unit labor costs beyond those in competing countries, limits on profit margins, government subsidization of some sectors, and uncertainty about the determination of the Government to follow restrained fiscal and monetary policies. To a considerable extent, the viability of future investment continues to depend on actions by the Government. Yet, what the Government gives, it can take away. If such an environment were to continue, it is hard to see how investment decisions could be made with any degree of certainty.

I have already alluded to the adverse effects on profits and investment of the current labor cost and labor market situation. Chart 2 on page 4a of the staff report shows a steady rise in relative unit labor costs during the 1980s, which has clear implications for business profitability. The recent liberalization of price controls and the plan to eliminate rent controls by the end of 1986 are welcome measures. The modifications in wage indexation designed to tie adjustments to future inflation targets and to insulate them from imported inflation is a very positive step. The much lower size of wage adjustments in the first eight months of 1986 under the new system should be very helpful in slowing inflation; however, attention should also be given to possible further modifications of the indexation system. Moreover, continuing labor market rigidities must surely contribute to inflation and to the rising unemployment rate. We hope that the authorities will review carefully the current laws and practices concerning layoffs, overtime, opening hours, and part-time and contract work, and will not merely attempt to administer existing controls more liberally.

Both the growing size of the public sector and the large fiscal deficits have had deleterious effects on the economy. The tax burden, measured by the ratio of central government revenue to GNP has been growing rather steadily--by 10 percentage points between 1980 and 1986. The expenditure ratio has increased by nearly 14 points, although there will be a modest decline by the end of 1986. The PSBR has been in the double digit range for the past five years and, despite a substantial decline in the targeted public sector deficit, it will remain in that range in 1986. We welcome Mr. Kyriazidis's assurances about the authorities intention to further reduce the PSBR in 1987. However, the achievement of the target for 1986 will depend on a mixed bag of revenue and expenditure factors. For example, half of the 7 percentage point decline in the PSBR cash deficit would result from exceptional revenue measures, including the retention of part of the benefit from the world oil price decline, the effect on fiscal drag by the failure to adjust tax brackets, and a special tax on nonwage income. Furthermore, over the long term, the major focus in reducing the PSBR will continue to be on the revenue side of the fiscal accounts. However, given the ratio of central government revenue to GNP of over 30 percent, caution should be exercised to avoid any adverse effects on savings and investment incentives. In addition, on the expenditure side, the rapid growth of social expenditures may not be sustainable. We look forward to the implementation of the measures aimed at placing the finances of the social insurance funds on a permanently sound basis, as referred to in Mr. Kyriazidis's opening statement. However, we wonder about the reason for a 25 percent increase in government employment since 1980 and believe that it is important that public enterprises operate more efficiently.

As is often the case, large fiscal deficits have in the past also resulted in larger increases in monetary aggregates, which have had undesirable effects on inflation. Some deceleration of monetary and credit expansion appears to be under way. However, it remains a matter of concern that Greece's inflation rate is well in excess of that of most European and other industrial countries. A reduction in the inflation rate to less than 10 percent in 1987 would be welcome, although that would still be well above the industrial country average. The persistence of negative real interest rates, at least until recently, must have something to do with relatively high inflation rates, and do not seem to be in keeping with the necessity to encourage savings. We would stress the importance of achieving and maintaining real positive interest rates in order to help restrain excess domestic demand, to limit the risk of capital outflows, and to promote the development of the financial markets. The continuation of the complex system of selective credit and of preferential interest rates does not seem consistent with the planned shift toward an efficient and market-oriented system of financial markets, which will be the aim of reforms to be announced at the end of 1986.

Greece, like other net oil importing countries is expected to benefit from the decline in world oil prices. In fact, more than 70 percent of the expected reduction in the current account deficit in 1986 will be attributable to this development. In contrast, the dramatic rise in the ratio of the deficit to GNP in 1985--from 6.5 percent in 1984 to 10 percent in 1985--reflected the stagnation of real exports and the rise in real imports by 13.5 percent. The persistence of such an underlying trade pattern into 1986 is not encouraging, although the effects of the 10 percent devaluation in October 1985 may not have been fully felt. We would encourage the authorities to aim at a somewhat more ambitious reduction in the current account deficit in 1987 along the lines suggested by the staff. This underlines not only the importance of a flexible exchange rate policy, but also of the need for a continued progress in domestic price and cost restraint. At the same time, the adequacy of the exchange rate is clearly called into question by the existence of a wide array of restrictions, including tariffs, quantitative restrictions, import licensing, the import deposit scheme, and export subsidies in various forms. To some extent, these are being dismantled in connection with Greece's integration into the EC. However, a more rapid pace would be desirable and would be in keeping with the broader role which Greece could play in preserving the openness of the world trade and payments system.

Greece's balance of payments prospects should take into account its very rapid buildup of foreign debt. In the past four years, total foreign debt has risen, on average, by 17 percent a year--the ratio of debt to GNP in 1985 was nearly 45 percent, and the debt service ratio was nearly 24 percent. The staff's medium-term scenarios show the debt service ratio to be in the 25-30 percent range through 1992. However, foreign creditors can be expected to assess Greece's creditworthiness not only in terms of these debt ratios, but also with respect to the country's overall economic policy stance.

It is this last point which I would like to stress. In our view, a favorable shift in Greece's economic policy approach has occurred and some important specific measures have been taken, with other measures being contemplated. A strengthening of the economy is of importance to the world economy and the Fund has an important surveillance role to play. Greece has obtained financial assistance from the EC in support of its economic program and we hope that the arrangement will prove successful. But I do not know if the Government's determination to correct its economic problems has yet been conveyed strongly enough and persistently enough to domestic and foreign observers of the Greek scene to sustain their confidence. I hope that a year from now it will no longer be necessary even to pose this question.

Mr. Wijnholds made the following statement:

In October 1985, Greece broke away from its gradualistic, and generally unsuccessful, economic policies and embarked upon a more determined adjustment program. Since that time the situation has improved somewhat, although progress has been uneven. On the one hand, significant improvements have been made in the area of wage determination and the control of prices. On the other hand, developments in the current account and in monetary policy have been rather disappointing. Moreover, in the area of fiscal policy, a more determined effort to control expenditure seems essential.

The improvement in the current account in 1986--from the alarmingly high deficit of 10 percent of GNP in 1985 to 4.5 percent of GNP in 1986--appears to be due largely to the improvement of the oil balance. Moreover, despite the import deposit scheme, the non-oil trade balance is expected to register only a very slight improvement in 1986, with the level for the entire year forecast to be the same as the level in 1982. This implies that the underlying deficit, corrected for the temporary factors of import restrictions and the decline in oil prices, has hardly improved. I believe that factors such as the lagged effect of the devaluation in October 1985, and the fall in demand from the Middle East, offer only a partial explanation for the current deficit situation. The very liquid state of the economy, exacerbated by the strong increase in domestic bank credit to the private sector as well as the larger than expected fiscal deficit, are also contributing factors. Therefore, there is an urgent need for tight financial policies.

I fully agree with the staff and the authorities on the need for maintaining competitiveness, all the more so as the present performance of exports and imports relies to a considerable extent on administrative measures and because Greece's inflation performance lags behind that of its main trading partners. In this context, I can support the staff's position that more flexibility in Greece's exchange rate policy is warranted. Indeed, to wait too long to adjust the exchange rate along the lines of the inflation differentials might give rise to disruptive speculative capital flows. However, a system of monthly devaluation does not seem compatible with Greece's ultimate aim of joining the European Monetary System (EMS). Therefore, the authorities should pursue policies aimed at improving competitiveness through domestic policies; in the meantime, they should be prepared to adjust their exchange rate. It should be stressed that any such adjustment should be accompanied by appropriate demand management policies and by moving away from administrative schemes to stimulate exports and to check imports. In this connection, I urge the authorities to eliminate their advance import deposit scheme soon. Furthermore, I note that the system of export subsidies will be changed in January 1987 in conjunction with the introduction of the value-added tax. Although I recognize it will not be possible to eliminate subsidies at the same time, I would stress the need for steady progress in this direction.

As to fiscal policy, it now seems that the attainment of a deficit of 11 percent of GNP is likely. That sharp reversal of past trends would be a major improvement. It should be recognized, however, that much of the improvement would be due to an increase in revenue, where the unexpected and perhaps temporary benefits of the oil price decline would again be involved. Therefore, the authorities should focus on expenditure restraint, in particular with respect to subsidies and grants. Moreover, further improvements in the financial position of public enterprises seems warranted. As to the financing of the budget deficit, I share the staff's view that the authorities should gradually eliminate their dependence on central bank borrowing and instead resort to financing from the domestic nonbank sector. In this context, I welcome the placement of a substantial number of bonds with the public, although I agree with the staff that it would have been preferable to have done this without exchange rate indexing.

Monetary policy developments in Greece are worrisome. The tables in the staff report indicate that at the beginning of 1986 there had been almost no deceleration of the various monetary aggregates. It would be very disappointing if the inflation targets were compromised in the future. It is disappointing to note that the authorities are not prepared to raise interest rates to a level above the inflation rate and that the trend toward positive real interest rates seems to have stopped in 1985. The disruptive effects of negative real interest rates on resource allocation and on domestic savings--and thus on investments--have been stressed on previous occasions. Moreover, it would seem to me that negative real interest rates are not compatible with the authorities' policy of stimulating productive investment, increasing domestic savings, and to promoting capital reflows. Furthermore, it seems that improvement in the institutional setting of monetary policy is needed. Monetary control is based on a complex system of credit rationing. Such systems are generally ineffective in promoting necessary monetary restraint and are not conducive to establishing confidence in the monetary authorities. In this respect, further steps toward a more market-oriented conduct of monetary policy are needed. There is also a need to strengthen the central bank's position.

Significant progress has been made in deindexing wages, and I welcome the authorities' intentions to give market forces a greater role in the wage determination process. However, if such a policy is to succeed, other rigidities have to be tackled as well. In this respect, I might mention the experience of other European countries, where it has been seen that government restrictions that have initially been implemented to protect employers have ultimately had the effect of increasing unemployment and limiting employment growth. Although some progress has been made on the other elements of structural policies, including price liberalization and the reform of ailing enterprises, many more reforms need to be undertaken. The level of investment in industry remains a cause for concern. I agree fully with the staff that measures are needed to counteract rigidities in both the labor and capital markets. In this connection, the agricultural sector should also be taken into account.

In conclusion, the success of the process of revitalizing the economy will depend crucially on adherence to strict financial policies and allowing for a much larger role for the dynamics of the marketplace. The authorities have made significant progress in a number of these areas, but progress in other areas has been inadequate. The increasingly heavy external debt burden and the need for a considerable recourse to financial markets in the coming years make it all the more urgent for Greece to continue and preferably speed up its adjustment efforts.

Mr. Goos made the following statement:

I would like to join the previous speakers in commending the Greek authorities for the adoption of their new economic program in late 1985, which, as has already been emphasized, constitutes a most welcome reorientation in the authorities' previous policy stance of gradual adjustment. That the previous policy stance was clearly unsustainable was demonstrated by the widening internal and external imbalances and the growing discrepancies that emerged in economic performance vis-à-vis other European countries.

Although the new policy orientation is welcome, we are concerned that the stabilization effort pursued by the authorities might not be adequate enough to successfully meet the considerable challenges that they are currently facing. In any event, notwithstanding the encouraging information provided in the supplement to the staff report and Mr. Kyriazidis's opening statement, one cannot rule out the possibility that the authorities would have to further tighten their adjustment policies in the future in order to attain their economic targets; such a tightening will, in all likelihood, become unavoidable if the current favorable external environment should change for the worse.

Unfortunately, there are already some signs that the authorities might miss their targets. In that regard, the slippages in the implementation of financial policies and the apparently stronger than expected expansion of domestic demand are cause for concern. Moreover, one has to note that the most recent improvement in the current account, although certainly welcome, has been too small to bring developments in that area back on track, and that improvements thus far seem to be attributable more to favorable exogenous factors than the necessary adjustment of domestic demand, as evidenced by the acceleration of the growth of imports of non-oil goods and services.

In general, we feel that the present stabilization program constitutes by and large an important first step in the right direction. However, we would have thought it desirable for the program to have been developed under a more comprehensive approach, including stronger emphasis on structural adjustment needs in order to strengthen market forces. In the context of the latter aspect, one has to note that labor markets, prices, competition among enterprises, as well as the financial system are subject to widespread administrative controls. Although the authorities have recently taken important steps to reduce such controls, most notably with regard to prices, more vigorous liberalization efforts in those areas would go a long way toward improving profits, the business climate, and the competitiveness of domestic industry. At the same time, confidence in the economy, especially on the part of foreign investments, could be expected to strengthen again. The staff appraisal leaves little doubt that there is still considerable need for further action in virtually all policy areas, and I fully agree with that appraisal.

Like the staff, we feel that the continuation of a firm stance of financial policies is critical to the success of the stabilization effort. An early and substantial reduction in the PSBR is of particular importance. As the central bank has correctly stressed in its latest Annual Report, without progress in the fiscal area, "it will be impossible to check inflation and bring the balance of payments deficit down to a sustainable level," which is a very clear statement. Therefore, we feel greatly encouraged that the authorities are now aiming at a more ambitious PSBR target than originally envisaged. Although, to some extent, fiscal adjustment will require stronger revenue efforts, the main contribution will have to come from the expenditure side, most notably through the reduction of subsidies, the rehabilitation of the so-called problematic enterprises, and the curtailment of the inefficient use of resources in administration and public enterprises. While the latest information on the PSBR provided in Supplement 2 of the staff report is quite encouraging, the prospects for a sustainable turnaround in the underlying trend are not yet clear.

Similar uncertainties exist in terms of the adequacy of the monetary policy stance. Although the recent slowdown in the growth of monetary and credit aggregates is welcome, the effectiveness of monetary policy continues to be seriously constrained by the large PSBR and its funding--to a large extent--through domestic bank credit and recourse to the central bank. This unfortunate linkage between fiscal and monetary policy clearly underlines the need for a comprehensive adjustment approach, and at the same time the need to develop less inflationary forms of deficit financing. Therefore, like others, I welcome the increase in nonbank financing projected for this year and also the intention of the Government to issue the first public bonds for deficit financing. I would encourage the pursuit of a more active interest rate policy with a view to securing positive real interest rates and restraining domestic credit demand.

I support the staff in urging the authorities to remove without undue delay the advance import deposit scheme that was reintroduced in 1985. I have nothing to add to their recommendations regarding exchange rate policy, except that exchange rate changes cannot be considered a substitute for sound financial and structural policies.

I would like to welcome the recent modification of the wage indexation mechanism as an important step in breaking the wage-inflation spiral. The beneficial effects of this move are quite evident. In particular, it should facilitate the task of securing a more balanced development of wages and profits, thereby strengthening investment activity and the international competitiveness of the economy. In view of these essential benefits, I would encourage the authorities to eliminate the remaining features of the indexation system as soon as possible.

Mr. de la Herrán made the following statement:

The number of important imbalances affecting Greece's economy might have allowed us to be critical about its deterioration and the lack of effective measures necessary to correct the situation. However, a substantial change has taken place since the end of 1985. The stabilization plan designed by the authorities and currently in progress represents a drastic change and offers the possibility of a more optimistic future. Therefore, I would like to congratulate the authorities for this courageous action marking the beginning of the rehabilitation of the economy. The relatively short lapse of time since the adoption of the measures included under the program does not allow for an accurate assessment of the efficacy of the plan. The staff report and Mr. Kyriazidis's opening statement have provided us with the latest available data, which shows mixed results in several fields. Most of the results are very encouraging and others, although not as favorable, must be considered in the light that the achievement of better results requires more time. In any event, the problem of the credibility of economic policy should be substantially alleviated by the favorable psychological impact that the announcement of the new measures will bring.

We fully agree with the authorities that these measures should be viewed "as a first step toward a comprehensive adjustment effort to be carried out over the following two years." Given the current unfavorable situation, the two-year horizon might need to be lengthened; however, the effort should avoid becoming excessively gradualistic.

Fiscal slippages have been the source of most economic problems in Greece. Taking the PSBR as the major indicator of the fiscal stance, it is quite clear that urgent measures are needed in order to reduce the public deficit and to alleviate the distortions created in other areas by the excessive borrowing being absorbed by the public sector. Measures are being taken to implement a tax reform, which has been long overdue. The introduction of the value-added tax will contribute to raising indirect taxes and, given the recent significant reduction of the inflation rate, the additional inflationary pressure resulting from its introduction should not be traumatic. Direct taxation should also be improved, together with tax administration and collection. Such improvements could have a favorable impact in reducing the overall social security burden, thereby also reducing labor costs, since two thirds of the contribution to the social security funding is made by employers.

Efforts on the expenditure side should be concentrated on stricter control of transfers and subsidies to public enterprises. A program to rehabilitate firms in crisis will probably need to pass through a reconversion process. This is usually a socially unpopular policy that should be undertaken after negotiations with all participants in the process of social development. The authorities are undoubtedly aware that they should be cautious about playing a protective role in sheltering inefficient enterprises; such a policy could initially be attractive, but will not be viable in the medium run, especially as Greece has an already overburdened public sector deficit.

One of the most intractable problems in the Greek economy has been the rigidity of the labor market and the excessive intervention of the Government in labor-related matters. Therefore, the measures contemplated under the program that would introduce more flexibility in the labor market are welcome. The current lack of business confidence could also be reduced if entrepreneurs had more mobility in adapting work hours to changes in demand. Overtime is subject to strict regulations by the Government and part-time employment has been excessively restricted. On the basis of information provided by the staff on these issues, one can conclude that the authorities have considerable room for maneuver in this field.

The reform of the wage indexation system will also be a substantial contribution to lowering labor costs to more acceptable levels, as well as reducing inflationary pressures. In this context, the figures provided by Mr. Kyriazidis are very positive. The problem of resistance by trade unions is clearly unavoidable; however, this difficulty will gradually disappear if government commitments are fulfilled in other areas of the economy to compensate for the loss in purchasing capacity that would result from the implementation of the new indexation mechanism.

The external sector also has problems. Most of the recent improvement in the external balance has been due to external factors, such as the sharp drop in oil prices and the considerable amount of subsidies coming from the EC. The effects of the adjustment efforts have not yet been felt, and might still take some more time. We believe that the authorities also share this view and correctly endorse a policy based on enhancing the competitiveness of the economy as a key factor in successfully adjusting the balance of payments position. Nevertheless, the exchange rate policy faces the problem of a tradeoff between necessary flexibility in the management of the exchange rate and the positive effect on expectations that might be achieved through preannounced monthly effective depreciations. It would be helpful if the staff or Mr. Kyriazidis could elaborate on this issue.

Notwithstanding that the level of external debt is quite high, the economy still enjoys enough credibility in international markets, and there is no doubt that the bold program now in progress constitutes a positive impulse to reinforcing such credibility. As to trade policy, I support previous speakers in urging the authorities for a prompt elimination of the advance import deposit scheme, which clearly constitutes an element that is inconsistent with the liberalization program designed by the authorities.

In conclusion, we welcome this discussion on the economy at a time when a positive turnaround has taken place. The latest information available already shows encouraging signs. While we would like to reiterate our strong support for the stabilization program, we would also caution against excessive complacency. The adjustment measures should not be a one-time effort; on the contrary, they should constitute a pattern of behavior within a framework of a medium-term adjustment process.

Mr. Schneider made the following statement:

I am in broad agreement with the comprehensive staff appraisal and the general conclusion that after years of poor economic performance and persistent structural problems, it was highly appropriate for the Greek authorities to abandon in October 1985 their gradualistic approach to adjustment and to switch to a more determined economic policy in order to overcome the still persistent internal and external imbalances in the economy. Such a shift is all the more welcome because it seems to signal that the authorities are ready to tackle their problems more vigorously than before, even if the results achieved thus far still present a rather mixed picture. Therefore, it is of utmost importance that the authorities persevere in their endeavors to adjust the economy to reach the targets of their stabilization program. In this respect, Mr. Kyriazidis's assurances in his comprehensive opening statement are very welcome.

Although it is encouraging to note a marked deceleration in the expenditures of the Central Government in the first few months of 1986, the shortfall experienced on the revenue side is a matter of concern. It seems that the existing imbalances in the fiscal area are not only the result of earlier inadequate fiscal policies, but indicate that the entire system needs to be reformed and streamlined in order to achieve consolidation of the fiscal position. The authorities' room for maneuver is very limited and will require a firm stance in fiscal policies. In this context, the intended introduction of the value-added tax, together with essential reductions in the system of subsidies, is certainly an important element of the reform of the tax system. It would be useful if the staff or Mr. Kyriazidis could provide information on the schedule of value-added tax rates being considered for introduction at the beginning of 1987. A firm fiscal policy stance should be supported by a strict monetary policy, a strong incomes policy, and a flexible exchange rate in order to maintain the competitiveness of Greek exports.

It is disappointing to note that the growth of domestic credit has exceeded the authorities' targets and has had negative repercussions on inflation and the balance of payments. In this respect, I share the staff's opinion that an increase in interest rates--which have been largely negative in real terms--would not only be beneficial for a better allocation of resources, but also for strengthening the capital base of commercial banks. Moreover, a high return on savings might induce a reflow of capital into Greece, thereby strengthening the balance of payments position.

I welcome the progress achieved thus far in wage indexation under the authorities' incomes policy, and encourage them to continue in this direction. At the same time, it would be highly desirable to remove other existing rigidities in the labor market. I am fully aware that this is not an easy task because there are many traditional factors that have to be overcome. Nonetheless, such an effort would play a significant role in the attempt to modernize the productive structure of the economy. In this context, the reintroduction of an advance import deposit requirement has been a regrettable decision because it is an ineffective tool for removing structural rigidities in the domestic economy and improving the balance of payments position.

Little progress has been achieved thus far in the external situation. I share the disappointment of the staff that the non-oil current account balance will probably remain in deficit through 1986. This is all the more regrettable because over 70 percent of the targeted improvement in the current account expected as a result of the decline in oil prices is a development which, given the present trend, will not repeat itself in 1987. In view of the fact that balance of payments financing by official sources, particularly the EC, is expected to decline sharply after 1987, a fundamental improvement of the current account through a flexible and credible exchange rate policy is of paramount importance in order to have adequate access to international capital markets in 1988 and beyond.

In sum, I welcome the clear shift in economic policy as a step in the right direction. It is of great importance to concentrate on the serious and deep-rooted imbalances in the economy to make an effort to remove the prevailing rigidities. However, the authorities will only succeed in the implementation of their stabilization program if they approach it in a determined and flexible fashion.

Mr. Foot made the following statement:

The Managing Director in his summing up of the discussion on the 1985 Article IV consultation with Greece (EBM/85/75, 5/17/85) had stated that, "in the view of Directors, a policy of gradual adjustment was no longer a viable alternative." He then set out some components of the needed policy reform. Since the time of that discussion, the authorities have made significant steps toward designing a program that would fulfill these needs and would establish important intermediate objectives relating to the current account deficit and inflation. In many ways it is too early to determine the extent to which the authorities have achieved these objectives. However, the latest supplement to the staff report and Mr. Kyriazidis's opening statement contain encouraging news about recent developments.

Among the achievements that are already apparent is the fall in the underlying rate of inflation. The changes in the wage indexation scheme would appear to improve the outlook for further falls in inflation as well as promoting needed recovery in profits. The authorities have also recognized the importance of improving the structural performance of the economy and have undertaken some helpful measures, including more liberal administration of existing labor market legislation. In addition, there appears to have been significant improvement in the balance of payments deficit.

I would agree with previous speakers that there have been some problems with the implementation of the program thus far. Clearly, with respect to fiscal policy, the situation is somewhat confused by the discrepancy between the cash and accruals measures; however, there do appear to have been some slippages in early 1986 on both the expenditure and revenue sides. The experience of my own authorities in attempting to introduce what is essentially a change in both actual trends and the public perception of trends is that slippages of this kind are unfortunate. Not only do such slippages affect fiscal improvements, but they also undermine the public perception of the objectives of the Government's policy.

Furthermore, it is clear that the benefit from factors such as the increases in yields on oil taxes and the fall in international interest rates may not be repeated over the life of the program. Therefore, I am glad to see that the authorities are taking measures to significantly strengthen the monitoring and control of the expenditure of the various components of the public sector and that the figures are converging toward the targets that have been set.

The authorities encountered some difficulties in meeting their credit targets in early 1986, presumably partly as a result of the pressures from the fiscal side. Therefore, it is encouraging to note that there are clear indications of a slowdown in the growth of monetary and credit aggregates in recent months.

Although the external position has strengthened, much of the improvement reflects the beneficial effect of the fall in oil prices as well as the effect of the temporary import surcharge. Recent developments appear quite encouraging in this respect, but the external position still remains a source of concern.

It would appear that while the adjustment program being implemented by the authorities represents an important step toward a sustainable position, the problems of implementation that have been encountered in 1986 emphasize the need for the authorities to persevere and strengthen their adjustment efforts where necessary.

The authorities' efforts to improve the structural performance of the economy will be of central importance in the medium term. Understandably, the adjustment effort has initially concentrated on the required demand side measures and has given less priority to structural reforms. Such an emphasis may be unavoidable during the initial stages of adjustment, but as the authorities recognize, these measures will also need to be complemented by reforms to improve the supply side of the economy. The poor performance of productivity in recent years--production fell by 1 percent a year between 1980 and 1984--underlines the need for active policies in this area. Perhaps the first step that will need to be taken by the authorities in the near future will be to move to a system that gives a greater role to market mechanisms in the wage determination process and that allows relativities to be determined more closely in line with relative productivity levels.

Although steps have been taken in recent years to improve the operation of monetary instruments, monetary policy remains somewhat inflexible and continues to rely upon direct controls on credit, while interest rates continue to be generally unresponsive to changes in economic conditions. I am encouraged to see that the authorities recognize the need for further action in this area.

The authorities are aware of the need to achieve a sustained recovery in profitability if investment and employment are to grow strongly over the medium term. The wage restraint envisaged under the incomes policy will provide important benefits in this connection. However, as the staff points out, the objective of strengthening profitability could also usefully be advanced by a faster pace of price liberalization. The need to resort to the temporary import surcharge is perhaps a reflection of the magnitude of the external imbalance facing the authorities. I hope that in the light of the strengthening of the external position evident in 1986, the authorities will be able to announce a timetable for its elimination in the near future.

In conclusion, many speakers have already noted the commendable steps made by the authorities toward designing an adjustment program that will begin to tackle the imbalances facing the economy. Those imbalances clearly are very large and the effort will take some time to mature. We wish the authorities well in their efforts to achieve their objectives.

Mr. Rye made the following statement:

The adoption of the first package of measures under a broad stabilization program in October 1985 was a welcome step in reversing the relatively poor performance of the Greek economy in recent years, which has been characterized by excessive rises in wages and public sector deficits, an accommodative monetary policy, a poor inflation performance, and a cumulative external debt.

Although much remains to be done, the Government's blend of demand management and supply-oriented policies has shown promising results in some areas. The devaluation of the exchange rate in October 1985 and the nominal effective depreciation in the rate since then is welcome, and is necessary for achieving a sustained turnaround in the balance of payments. In addition, the modification in the wage indexation arrangement and the authorities' greater emphasis on market mechanisms in the wage determination process are welcome developments. The use of ex ante inflation targets and discounting for import price changes will help reduce the rate of inflation and allow exchange rate policy to be implemented more effectively. Recent steps to liberalize price and rent controls, promote direct investment through the removal of capital controls, and to improve the finances of public enterprises will also contribute to the stabilization program.

A number of concerns about the economic situation remain. In particular, slippages in the implementation of key financial policies need to be remedied and further regulation and liberalization of key sectors of the economy should be pursued. A better fiscal policy remains the keystone to a substantial and sustained improvement in the economy. The authorities clearly recognize that a significant reduction in the PSBR in 1986/87 will be necessary to support the Government's wages, inflation, and exchange rate policies. Following a number of tax measures and the recent increase in utility prices and significant expenditure savings--derived in part from smaller wage rise increases--the authorities may yet meet their PSBR target for 1986, despite the early slippages. However, the underlying fiscal position remains fragile, while the heavy reliance on oil taxes continues.

We agree with the staff that the Government should improve its revenue prospects by broadening the direct tax base, reducing tax evasion and collecting arrears, and through improvements in the profitability of public enterprises. We also support continued expenditure restraint by reducing the extensive subsidies financed from the budget and strengthening control over social security. I hope that the authorities will not continue to rely on windfall gains--such as lower interest payments owing to the fall in the U.S. dollar--to offset overruns in other areas of expenditure. It is encouraging to note that, after monetary aggregates had exceeded the target in early 1986, the authorities had taken measures to tighten domestic credit. While it seems that these measures are broadly adequate for the present, it is essential that a tight reign be kept on credit growth, particularly in the absence of any underlying improvement in the balance of payments. It is also encouraging that in the first half of 1986 the rate of inflation has been kept within the program target, thus putting single digit inflation in 1987 within reach--a goal I would urge the authorities to pursue vigorously. However, it should be noted that Greece's inflation rate would still exceed the rates in its trading partners.

Although early slippages in fiscal and monetary policy seem largely to have been addressed and policies seem to be producing the restraint required to meet the authorities' targets, the balance of payments has not shown any real underlying improvement. The superficially better results largely reflect the reduction in oil prices and a substantial increase in agricultural subsidies from the EC, which are now expected to total about 3 percent of GDP--$1.2 billion in 1986. The non-oil trade balance deteriorated in the first half of 1986, while the non-oil current account declined by only $40 million. A substantially reduced growth of non-oil imports of goods and services is essential in the second half of 1986 and in 1987 if a non-oil current account balance is to be achieved in 1987. I fully agree with the staff that adequate early adjustment in the balance of payments is needed in view of the prospective increase in Greece's recourse to capital markets in the coming years. With the expected loss in non-oil terms of trade, the Government will need to maintain firm financial policies if it simultaneously attempts to reduce the country's significant protection levels and to achieve the desired non-oil current account balance.

Other areas which warrant the authorities' early attention are the continued excessive regulation of labor markets, prices and interest rates, and the widespread use of subsidies. Deregulation and reduced protection would improve the efficiency and market responsiveness of the economy, and complement the demand management policies already being adopted. In this context, I support the staff recommendation that the Executive Board not give approval to the advance import deposit requirement.

The staff documents provide an interesting, and indeed disturbing, account of the effects of EC membership on the economy. One point worth emphasizing is the redirection of trade. Since Greece joined the EC in 1980, the share of EC countries in Greece's total imports has risen from 41 percent to 49 percent, while the share of non-oil developing countries has declined from 20.5 percent to 8 percent, and non-EC industrial countries from 24 percent to under 12 percent. Although undoubtedly there are many reasons for this situation, the extensive use of agricultural price supports and subsidies within the EC has unquestionably worked against the interests of more efficient agricultural producers and, as indicated in Appendix I of the supplement to the staff report on recent economic developments notes, has led to a deterioration in Greece's own terms of trade for agricultural products.

Mr. Isleifsson made the following statement:

I would like to join other speakers in welcoming the authorities' stabilization effort which marks a clear shift in economic policy in Greece. However, like the staff, I have doubts as to whether the adjustment efforts are ambitious enough. I am also concerned that some deviations from the announced policy course have emerged, particularly in the areas of fiscal and monetary policy.

The authorities project that over 70 percent of the targeted improvement in the current account will take place owing to the fall in oil prices. With the non-oil current account expected to remain in deficit, albeit a significantly reduced one according to Mr. Kyriazidis's opening statement, an effort for a better balance would have been desirable. The deficit inevitably casts doubt on the authorities' prospects of attaining their objective of stabilizing the external debt by 1988.

The authorities' gradualistic approach toward external adjustment is mirrored in their approach to stabilization of inflation, where the aim is to bring about the deceleration of consumer prices from 25 percent at end-1985 to 10 percent by mid-1987. Progress in this field as described by Mr. Kyriazidis's opening statement has been encouraging. Inflation appears to have been fed by accommodative monetary and exchange rate policies, together with a wage-price spiral generated by a relatively elaborate indexation system. I welcome the modification of the indexation mechanism, which should be regarded as a first step toward a phasing out of the mechanism. An ex ante system of indexation, based on the official inflation target, however, is not without problems. These government targets are liable to become the lower bounds of the public's inflationary expectations, without the lowering of which inflation would be difficult to bring down.

Apart from adjustment, the authorities face the task of modernizing an economy which in many respects appears to have become antiquated. It is of vital importance that the price mechanism and functioning of markets operate so as to bring about an optimal allocation of resources. This applies to the factor markets as well as the groups and services markets. Regarding the labor market, it is clear that the indexation mechanism has not only made it difficult to adjust real wages, but will also lead to a forced narrowing of wage differentials, thereby cutting the linkage between wages and productivity developments. The labor market has been adversely affected by excessive regulation arising from substantial government intervention; among these effects is the high cost of dismissals with collective layoffs which have to be approved by the Ministry of Labor. The Ministry also has tight limits on overtime work, which apparently are supported by the labor unions. Given the harmful effects on employment and labor mobility that these and other rigidities have had, I do not agree with the authorities that a more liberal administration of existing legislation will be sufficient to ensure adequate progress in this area; rather, I believe the new practices should be based on an overhaul of the existing legislation.

Greece still maintains a comprehensive system of interest rate regulations. Although the authorities have acknowledged for a number of years that the existing system of credit and interest rate controls has led to inefficiencies and a number of distortions, they have moved hesitantly toward reform in this area. I would suggest that a strong effort in this field would be of great importance in order to support the adjustment effort currently in place. In a longer-term perspective, it seems clear that the necessary restructuring of the economy, including industrial reorganization, would be jeopardized by the absence of radical reform in this area.

As to the market for goods and services, I welcome the liberalization measures that have been taken with regard to price controls. I also welcome the planned abolition of rent controls. However, it is disappointing that the authorities do not envisage an early abolition of the advance import deposit scheme. A timetable for the phasing out of this scheme ought to be established.

In sum, I would encourage the authorities to strengthen their resolve to bring about a lasting adjustment coupled with efforts to improve the effectiveness of the economy through liberalization of markets and other structural measures. Such an effort, long overdue in the opinion of many, requires a considerable amount of political courage and endurance. In any event, the policy agenda appears to be full.

Mr. Hodgson made the following statement:

Considerable progress has been made in strengthening economic policy in Greece during the past year. This progress was entirely necessary, since the economy appeared to be drifting toward unsustainable balance of payments and fiscal positions. I would like to join other Directors in welcoming the shift in policy since October 1985, although the strategy now in place is not as complete as might be desired and needs to be supplemented by more aggressive measures to tackle the rigidities in underlying markets.

A year ago, it was clear to us that Greece would require a strong shift in policies, possibly within the framework of a stand-by arrangement with the Fund. However, a stand-by arrangement has not been requested, in part because Greece has been able to secure exceptional financial assistance in the amount of ECU 1.75 billion over two years from the EC. This level of financing is exceptional and exceeds 300 percent of Greece's quota with the Fund. Certainly, the Fund cannot provide such generous assistance to its members. The EC is entitled to use its resources according to its own set of priorities, and from a European perspective there may be good reasons to support or even to encourage a large-scale transfer of resources within the Community, although the issue of agricultural transfers raised by Mr. Rye is cause for concern. Nevertheless, to the extent that the exceptional EC resources finance balance of payments adjustment, I wonder whether such assistance might tend to reduce the Fund's role in helping industrial countries to adjust. This assistance may also tend to reinforce the view that the Fund only provides financing to developing countries. I also wonder about the nature of the EC's conditionality, which no doubt is different from the conditions which would normally accompany a Fund stand-by arrangement. It would be useful if the staff commented on these issues.

Fiscal policy slipped badly during 1985, with the PSBR increasing to an unsustainable level of 18 percent of GNP. The authorities' desire to bring about a substantial reduction in the PSBR during 1986 and 1987 is commendable, particularly if the PSBR target of 11 percent for 1986 is actually met. I agree with the staff that expenditure targets must be met, and the results thus far are encouraging, although the deterioration of social security institutions is of concern. Efforts to tighten tax administration must also be strengthened if the fiscal imbalance is to improve.

Monetary policy will have to become more restrictive if the plan for net fiscal adjustments are to be adequately supported and if inflation is to decline. The authorities' monetary targets for 1986 had been reduced accordingly. However, monetary developments in the first quarter of 1986 caused concern because aggregates grew faster than the target growth rates. We welcome the authorities' measures to slow the growth of bank credit by raising some preferential interest rates and tightening the terms for consumer credit. Nonetheless, as described in the staff report, the financial system continues to be highly regulated, with a variety of controls over credit allocation and interest rates. In view of other macroeconomic adjustments now being undertaken, greater reliance should also be placed upon market mechanisms in implementing monetary policy.

Similar concerns can be expressed regarding rigidities in labor markets and pricing and industrial policies. We certainly welcome the tight incomes policy applied since October 1985, which has brought about a needed reduction in real wages and should contribute to an improvement in enterprise profits. We also support the introduction of a wage modification mechanism which provides an ex ante system of indexation based on projected domestic inflation. However, labor markets in Greece are still very rigid in terms of wage determination, labor mobility, and hiring policies. Accelerated efforts to remove labor market rigidities can help to improve the employment prospects over the medium term.

As to pricing and industrial policies, we welcome the steps that had been taken to liberalize price controls and to make the economy more open to foreign investment. However, the state continues to intervene in many areas of industrial policy without clear benefit; thus, greater flexibility is required.

The devaluation in October 1985 was necessary to restore Greece's external competitiveness, and continued exchange rate flexibility will be required, particularly as long as the inflation rate exceeds inflation in major trading partners. We agree with the desirability of maintaining a measure of flexibility in exchange rate management rather than adopting a policy of preannounced monthly depreciations. However, the authorities will have to use their flexibility to strengthen competitiveness according to circumstances, and not allow competitiveness to be lost. Failure to devalue the exchange rate when necessary will only push the burden of adjustment more fully onto the fiscal position. We support the staff's recommendation not to approve the continuation of the import deposit scheme. It is clear that the authorities will have to extend their policy strategy into 1987 and beyond in order to fully strengthen the external accounts. The assurances provided by Mr. Kyriazidis that the authorities fully intend to strengthen policy further in 1987 are welcome. We wish them every success in those efforts.

Mr. Nimatallah said that it would be useful if the staff could provide more information on the assistance provided by the EC to Greece.

The Director of the European Department said that the EC had a number of financial facilities available to its membership, which had been used on some occasions. He recalled that approximately two years ago France had drawn heavily from the Community loan mechanism and had subsequently repaid a major part of that loan. Greece had taken a loan of ECU 1.7 billion from that facility approximately one year ago. The financial facilities were available with specific conditionality to the member states on application. Applications were reviewed and processed in a manner similar to Fund procedures. An application would initially be considered by the EC Commission and the Monetary Committee, followed by a mission by EC staff to the country in question that would look more closely at the amount requested and the policies and recommendations would then be made. The system had borrowed from the experience gained in the Fund. Executive Directors would be given full details of the amounts of the facilities and the rates of interest charged on them.

Mr. Nimatallah said that if such a document were circulated, it should include as much information as possible about the kind of conditionality that the EC imposed and the relationship of its financial programs with Fund surveillance. He wondered whether such programs would not compete with the Fund and its work.

The Executive Directors agreed to continue their discussion in the afternoon.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/86/140 (8/28/86) and EBM/86/141 (8/29/86).

3. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/86/208 (8/27/86) is approved.

APPROVED: May 8, 1987

LEO VAN HOUTVEN
Secretary