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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/75

3:00 p.m., May 17, 1985

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	A. K. Diaby, Temporary
	D. C. Templeman, Temporary
	G. Ercel, Temporary
	X. Blandin
M. Finaish	
H. Fujino	
	B. Goos
J. E. Ismael	
	L. Leonard
	J. R. N. Almeida, Temporary
	E. Olsen, Temporary
	W. K. Parmena, Temporary
	M. A. Weitz, Temporary
	E. M. Taha, Temporary
P. Pérez	
J. J. Polak	J. de Beaufort Wijnholds
C. R. Rye	
	H. Alaoui-Abdallaoui, Temporary
	A. S. Jayawardena
	T. A. Clark
	N. Coumbis
Zhang Z.	Wang E.

L. Van Houtven, Secretary
K. S. Friedman, Assistant

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Also Present
African Department: E. A. Calamitsis. European Department: L. A. Whittome, Counsellor and Director; P. B. de Fontenay, Deputy Director; D. A. Brodsky, B. Christensen, P. L. Hedfors, W. E. Lewis, G. Szapary, H. Vittas, P. M. Young. Exchange and Trade Relations Department: J. T. Boorman. Legal Department: W. E. Holder. Advisors to Executive Directors: D. Hammann, H.-S. Lee, G. E. L. Nguyen, T. Sirivedhin, A. Steinberg. Assistants to Executive Directors: E. M. Ainley, Bo T., M. B. Chatah, G. D. Hodgson, D. J. Robinson, A. A. Scholten, L. Tornetta.

1. GREECE - 1985 ARTICLE IV CONSULTATION

The Executive Directors continued from the previous meeting (EBM/85/74, 5/17/85) their consideration of the staff report for the 1985 Article IV consultation with Greece together with a proposed decision concluding the 1985 Article XIV consultation (SM/85/116, 4/25/85; and Sup. 1, 5/13/85). They also had before them a staff report on recent economic developments in Greece (SM/85/122, 5/3/85).

Mr. Finaish said that the performance of the Greek economy over the previous year had improved in a number of areas, although the overall outcome had been less satisfactory than the authorities had expected. GDP growth had rebounded after years of stagnation, and the inflation rate had continued a downward trend, albeit slowly. In addition, the persistent decline in revenues from commodity exports as well as from tourism over the previous several years had been reversed in 1984. However, the external current account deficit had increased, business investment had continued to decline, and the urban unemployment rate had continued to rise.

The staff's interpretation of the outcome in 1984, and particularly whether or not it represented a serious relapse in the adjustment effort begun in 1982, differed somewhat from the authorities' interpretation as reflected in Mr. Coumbis's opening statement, Mr. Finaish went on. However, it was clear that the 1984 outcome left the authorities with less room for maneuver in the coming period to achieve the balance of payments and other objectives of the five-year plan. Conclusion on the pace of adjustment that would enable the authorities to steer the economy toward a sustainable balance of payments position without jeopardizing other economic objectives depended partly upon assumptions concerning policy and the behavior of exogenous variables. The staff and the authorities had not made identical assumptions. However, there was a clear need for a prompt policy response by the authorities if their assumptions were to prove too optimistic. The need for that response was particularly urgent in light of the updated information in SM/85/116, Supplement 1. It was encouraging to note from Mr. Coumbis's opening statement and from the latest annual report of the Bank of Greece that the authorities saw the need to speed up the short-term adjustment effort and were determined to set more ambitious stabilization targets in the coming year.

The authorities clearly recognized the importance of reducing the public sector borrowing requirement, which had been a major factor in the balance of payments imbalances and the inflationary pressures in recent years, Mr. Finaish said. To achieve that objective, however, the authorities seemed to be relying almost entirely on revenue-raising measures; no significant reductions in expenditures were envisaged. It was noteworthy that the projected 12 percent real increase in tax receipts was to arise mainly from improved tax collection and similar reforms despite a reduction in income tax rates. Achievement of that target would be a positive development that would facilitate the reduction in the public sector deficit without jeopardizing the public investment program to which the authorities attached great importance.

However, if the revenue outcome fell short of expectations, it would be even more crucial to intensify efforts to find ways of reducing current public spending, which was forecast to increase more rapidly than investment expenditure in 1985, Mr. Finaish went on. Given the wage indexation mechanism and the rising portion of public expenditure allocated to debt servicing, the scope for cutting current expenditure admittedly was not substantial. Therefore, the authorities might find it advisable to take another look at the wage-setting mechanism, which had clear implications for fiscal adjustment, inflation, and competitiveness.

The authorities' intention to adhere to a relatively tightened monetary policy in 1985 was welcome, particularly in light of the credit overruns in 1984 that probably helped to explain why only a modest reduction in inflation had been achieved in 1984, Mr. Finaish commented. He had noted the authorities' explanation for those overruns, which the authorities considered to be temporary in nature, and their intention to adhere to the statutory limit on central bank financing of government expenditure. The upward adjustment in interest rates along with institutional reforms in the financial sector were also positive steps toward a more efficient allocation of credit in the economy. The direct sale of treasury bills to the nonbank private sector planned for 1985 was a welcome development that could help in the fight against inflation by reducing the monetization of the deficit. It should be noted, however, that unless the public sector borrowing requirement were contained, the absorption of private savings by treasury bills might intensify the pressure on private sector profitability and on business investment and might cause further increases in debt service obligations, which were already high. Those conclusions underscored the need to give priority to reducing the public sector deficit.

Tackling the structural problems facing Greek industry was one of the major challenges for medium-term development strategy, given the deep-rooted and widespread nature of those problems, Mr. Finaish said. Greece's entry into the European Communities (EC) had increased the urgency of correcting the structural imbalances in the industrial sector and of improving its competitiveness. The profitability of private enterprises was clearly a key to their financial viability and to providing an incentive for the private sector to expand and invest. A reversal of the rather rapid decline in private investment over the previous several years was needed if medium-term growth and development objectives were to be achieved. That conclusion suggested that wage and pricing policies should be set carefully so that adequate investment incentives would be provided.

It was particularly important to implement carefully the 1983 legislation regarding government rehabilitation of problem enterprises that were viable in the long term, Mr. Finaish considered. Implementation of that legislation should not be permitted to create a long-term burden on the Government. In passing, he noted that the staff or Mr. Coumbis could usefully comment on the impact on commercial banks of the arrangement with respect to the debt owed by problem enterprises mentioned on page 10 of the staff report.

The importance the authorities attached to achieving the balance of payments objective in the five-year plan was welcome, Mr. Finaish commented. While the export performance in 1984 had been encouraging, the reduction in the current account deficit to about 3 percent of GNP by 1987 would require intensified efforts to improve the competitiveness of Greek exports. Achieving that objective would depend particularly on the success of the industrial restructuring process that the authorities considered of primary importance as well as on the maintenance of a realistic exchange rate policy. In that connection, he agreed with Mr. Coumbis that the extent to which exchange rate policy would be needed to restore competitiveness would depend upon the pace and effectiveness of the structural reform in the industrial sector. However, it would be important to avoid an upward drift in the exchange rate, particularly in light of the significance of tourist income in the balance of payments and of the need to sustain the recovery of the tourist sector.

The Greek economy was passing through a difficult period, Mr. Finaish concluded. The authorities were aiming not only to make financial adjustments, but also to make significant structural changes that, to a large extent, would determine the course of the economy over the medium and long run. The required balance among the authorities' various objectives was a delicate one, particularly in light of the narrow room for maneuver reflected in the medium-term debt scenarios. At the same time, however, he fully understood the many constraints within which the authorities must operate. The economic difficulties in Greece obviously were not unique. Directors were all too familiar with the pressures that faced policymakers in addressing major economic problems: problems which in the case of major countries could have worldwide implications. For those reasons, the present discussion and the staff appraisal had perhaps been somewhat too critical. He wished the authorities well in their efforts.

Mr. Zhang remarked that the staff report clearly indicated that after three years of decline, economic activity in Greece had started to pick up in the first half of 1984, significantly helping to contain the internal and external imbalances. However, developments in some sectors were a cause for concern: manufacturing production at the end of 1984 had been lower than the peak level of 1980; the rate of unemployment was increasing; gross fixed capital formation had continued to decline; the rate of inflation had decelerated somewhat but still remained high; the overall government policy stance had continued to be easy during 1984; and some of the policy targets for 1984 had not been achieved.

During the previous several years, the fundamental aim of government policy had been to make needed adjustments and to transform the economy over the medium term, Mr. Zhang continued. Since 1982 greater emphasis had been placed on short-term stabilization in order to place the economy on a path of steady, noninflationary growth. A five-year plan had been adopted to define targets and guide government policy. The authorities had found it expedient to use a gradualist approach to achieve its policy objectives. Indeed, they may have had no other choice. The existing structural imbalances were long standing and had resulted basically from the pattern of economic growth and the development policies in the early 1950s; moreover, economic policymakers in Greece faced various social, political, and institutional constraints.

The staff disagreed with the authorities' gradualist approach, Mr. Zhang noted. The staff strongly believed that the present pace of adjustment should be accelerated, and its evaluation of the authorities' individual policies was based on that conclusion. It was disappointing that the staff report did not include quantitative targets for the major macroeconomic variables, estimates of their likely impact, and the policies that would be appropriate if the authorities were to decide to accelerate the adjustment effort. The staff's quantitative analysis was limited to the medium-term external debt scenarios, which seemed inadequate for the purpose of the present discussion. Broadly speaking, the situation in Greece was similar to that in other industrial countries with large budget deficits, structural rigidities, rising unemployment, and external imbalances. For industrial countries other than Greece, the staff had generally recommended a gradualist approach to solve those problems. Why had the staff not recommended a similar approach for Greece?

The staff had not fully described the analytical model it had used in assessing inflation in Greece, Mr. Zhang commented. The staff had assumed that the wage and price spiral had been induced and maintained by rising wages. He wondered whether the continuing inflation in Greece had not also been due to excess demand; after all, total real consumption had been steadily increasing over the previous several years while the growth of real GNP and industrial production had been negative or had decelerated. He also wondered whether the rising import prices resulting from the continuing depreciation of the currency had not also been an important factor in the inflation in Greece. After all, in 1980-83 the GDP deflator had risen in line with the increase in import prices; at the same time, the prices of final products for home consumption had risen in line with the prices of imported final products.

The staff had noted the declining trend in investment but had failed to analyze the change in its composition, something that was crucial to gaining a full understanding of the problems in the investment area, Mr. Zhang remarked. In 1980-83 total gross fixed investment had fallen by Dr 9.7 billion, of which Dr 6.2 billion--or 64 percent--was accounted for by residential construction and Dr 2.7 billion--28 percent--by investment in the manufacturing sector. The declines in those two categories probably had not been due to the same factors and should have been analyzed separately.

The authorities' explanation that sluggish demand was the main cause of the continued weakness in private investment was plausible, Mr. Zhang went on; after all, real disposable income had fallen substantially in 1980 and 1983 and had increased by only 1-1.8 percent in 1981, 1982, and 1984. Such changes had probably limited the demand for housing as well as consumption; investment in turn had probably been affected. The staff had not separated the various categories of investment and regarded the declining trend in profits as the main factor in the behavior of investment. According to the staff, the decline in profits was attributable to the continuous redistribution of income from profits to wages over the previous decade. The decline in profitability would certainly have adversely affected investment, but that decline was not attributable to the change in the distribution of income in favor of wages. Other factors had been directly responsible for the decline in profits, such as the low capacity utilization and the structural problems in the industrial sector. The conclusion that rising real wages and unit labor costs since 1981 had been responsible for the decline in profits was not fully supported by the official data. Gross profit rates in manufacturing had been fairly stable since 1979; only net profit rates had been declining since 1979. Moreover, the uncertainties facing businessmen because of the continuous inflation had almost certainly adversely affected private investment.

In supporting its conclusion that there had been a continuous increase in the relative share of wage incomes in GDP since 1980, the staff had noted that there had also been a continuous increase in the ratio of the wage bill to nonagricultural GDP at factor cost, Mr. Zhang went on. In his view, it was impossible to say on the basis of those data whether or not there had been a redistribution of total income in favor of wages. Such conclusions could be drawn only if data on income in agriculture--an important sector in the Greek economy--income from property and entrepreneurship, and data on undistributed profits and net income payments from abroad were also available. Since such firm conclusions could not be drawn, he wondered whether the staff recommendation to place the burden of adjustment entirely on wage earners was appropriate.

There seemed to be broad agreement between the staff and the authorities that exchange rate policy should be used flexibly to increase the competitiveness of exports, Mr. Zhang remarked. However, the authorities seemed to place less emphasis than the staff on the importance of exchange rate policy. In his opening statement Mr. Coumbis had mentioned that exchange rate policy "will continue to be flexible but will be assigned a secondary role, provided that the primary causes of the loss of competitiveness are successfully tackled." In contrast, the staff was inclined to encourage the authorities to resort to devaluation to maintain competitiveness. Constant resort to devaluation probably would intensify domestic inflationary pressures.

The Greek economy was likely to continue to face a variety of imbalances throughout 1985, Mr. Zhang said. The most important short-term imbalances were likely to be in the financial and external sectors and would probably contribute to a continued high rate of inflation. The heavy dependence of the external sector on earnings from invisibles and on private capital inflows made Greece highly vulnerable to adverse international economic developments. That many of the achievements recorded in 1984 had not been maintained in early 1985 was particularly worrying. However, he agreed with Mr. Coumbis that some of the recent developments should be seen as the short-term costs of the necessary structural reforms. The authorities' recognition of the need to speed up the short-term stabilization effort and to establish more ambitious targets for 1985 was reassuring.

Mr. Alaoui-Abdallaoui stated that he agreed with the staff appraisal. The proposed decision was acceptable. Greece's economic and financial performance in 1984 had generally been below expectations despite the moderate increase in real GDP--after three years of negative or very low growth--the modest decline in the rate of inflation, and the progress in making major structural reforms. Those developments had been overshadowed by the deterioration in the domestic financial accounts and by the further increase in the external current account deficit. In addition, the continuing decline in private fixed investment had significantly accelerated in 1984.

Over the previous several years, the authorities had faced a major challenge in dealing with the particularly difficult economic conditions in Greece, Mr. Alaoui-Abdallaoui went on. The Greek economy had been seriously affected by the world economic recession and had experienced major distortions and imbalances resulting largely from Greece's long-delayed adjustment to the structural transformation of the world economy in the 1970s. In addition, Greece's entry into the EC had necessitated a rapid adaptation of its economic and financial structures to a new, highly competitive environment. Furthermore, owing partly to the authorities' commitments to the electorate--particularly regarding the distribution of income in favor of lower-income groups--the adjustment strategy had been a gradualist one, aimed primarily at alleviating the social costs of the economic stabilization and structural reform efforts.

The progress under the authorities' strategy had been limited, and some of the imbalances in the economy had apparently worsened in 1984, Mr. Alaoui-Abdallaoui said. Continuing the same policy stance in 1985 obviously would not be sufficient to restore an adequate environment for growth and strengthen the fiscal and external positions so that the authorities could successfully deal with the increasingly difficult external debt situation. In his opening statement Mr. Coumbis had noted that the authorities shared that view and recognized the need to accelerate the short-term stabilization effort.

The progress in the fiscal sector in 1982 and 1983 had been reversed in 1984, as the public sector net borrowing requirement had increased to a record 15.5 percent of GNP, Mr. Alaoui-Abdallaoui noted. That development clearly underscored the need for more ambitious adjustment targets, even though the increase in the public sector net borrowing requirement had been due partly to the delay in adjusting petroleum prices and to much higher interest payments on the public sector debt. The large public sector deficit had enabled the authorities to compensate somewhat for the sharp and prolonged decline in private fixed investment and to implement a judicious industrial policy. However, the deficit also was keeping the rate of inflation in the range of 18-20 percent--substantially above the rates in Greece's trading partners--and it had led to an increase in the public domestic and external debt that was a growing cause for concern, as interest payments had reached the equivalent of 7 percent of GDP in 1984.

The scope for curtailing public sector capital expenditure would clearly remain limited as long as private fixed investment was weak, Mr. Alaoui-Abdallaoui said. The authorities' efforts to increase revenue and to check current expenditure while improving the financial position of the public enterprises were obviously in the right direction, although they would cause only a modest reduction in the net public sector borrowing requirement in 1985.

A number of factors had apparently played a role in the decline in private fixed investment, Mr. Alaoui-Abdallaoui went on, including the rapid rate of inflation, the high nominal interest rates, and the continued erosion of Greek industrial firms' profit margins, especially as the restructuring required by the changed international economic environment had coincided with the dismantling by Greece of its protection against European exports following Greece's entry into the EC. The increase in real wage costs in Greece had also contributed to the country's poor investment performance. The legislation enacted in 1982-83 to offer substantial incentives for private investors was basically appropriate. However, controlling the huge public sector deficit and containing inflation would continue to be the main ways to restore private investment.

The authorities had made major institutional reforms in the financial system since 1982, Mr. Alaoui-Abdallaoui noted: the interest rate structure had been modernized; stricter limits had been placed on government borrowing from the Bank of Greece; and the control over credit creation by commercial banks and specialized credit institutions had been increased. In 1985, the authorities planned to encourage the development of nonmonetary financial assets that should enable the Bank of Greece to expand its instruments for monetary control in the medium term. However, the efforts to tighten monetary and credit policies had not prevented considerable overshooting of the targets for the monetary aggregates, owing mainly to the excessive borrowing by the public sector.

The authorities were well aware that recent developments in Greece's external payments were a cause for concern, Mr. Alaoui-Abdallaoui remarked. Indeed, reducing the external current account deficit to 3.5 percent of GNP by the end of the five-year development plan in 1987 was the main target of their economic policies. However, despite the realistic exchange rate policy and the introduction of export promotion incentives, the current account deficit had further increased to 6.6 percent of GNP in 1984; and the external debt situation had continued to deteriorate despite the large portion of nondebt-creating inflows in the financing of the deficit. It would be essential to reverse those trends in 1985. The authorities were committed to cutting the current account deficit by 1.5 percent of GNP in 1985.

Although the authorities had made only limited progress in correcting the domestic and external imbalances, they had introduced major structural reforms, the effects of which would be evident only over the medium term, Mr. Alaoui-Abdallaoui said. In particular, they had made changes in the financial system that would increase the effectiveness of monetary policy, introduced a more realistic exchange rate policy, decontrolled prices, and promoted small and medium-sized enterprises. Finally, a comment on the effect on Greece of the entry into the EC of Spain and Portugal would be helpful.

Mr. Jayawardena remarked that he fully agreed with Mr. Coumbis that, like the Greek Government, many governments had inherited a host of economic problems from the 1970s. The Greek authorities had shifted economic policies in 1982, when their stabilization effort had been started. However, they had experienced a setback in 1984 even though a number of corrective measures had been introduced in that year. Still, he, unlike most other speakers, did not attribute the retrogression in 1984 to any inadequacy in the authorities' adjustment efforts. He was inclined to agree with Mr. Coumbis that the problems facing the economy were structural in nature and deeply imbedded, and that perseverance over the longer run would be needed to correct them. That conclusion was reinforced by the staff's analysis in Appendix I of SM/85/122 of the effects of Greece's EC membership.

The staff reports indicated that little had been done to adapt the structure of the Greek economy to that of the European economies in preparation for Greece's entry into the EC, Mr. Jayawardena continued. The staff had concluded that Greece's formal entry into the EC had caused disruptions in the economy, particularly because of the substantial deterioration in Greece's terms of trade. The effects of those adverse developments were to be offset by financial transfers and loans from the EC, but that assistance would be temporary. The staff had concluded that, on balance, Greece probably had not suffered from its entry into the EC, although there might well have been considerable trade diversion that could have fueled domestic inflation and affected domestic demand management. The agricultural sector was more important in Greece than in any other EC country, and Greece's agricultural production and exports were concentrated in products for which there was only a limited market in the EC; at the same time, EC agricultural subsidies were concentrated on products that accounted for only a small share of Greek agricultural output.

The staff had also noted that European exports had apparently gained a larger market in Greece, while the gains by Greece in European markets had been insignificant, Mr. Jayawardena went on. In fact, the share of Greece's manufactured exports in European markets had declined, owing to the reduced competitiveness of Greece's manufacturing sector. Given the number of other so-called EC entry shocks, he would be reluctant to conclude that Greece's overall performance in 1984 had been inadequate or disappointing. It was difficult to say precisely how many of the problems facing the Greek economy in 1984 had been due to integration into the EC as opposed to policy shortcomings. In that connection, it was important to remember that Greece had recorded strong export market growth in the 1970s and had not faced serious problems until the second oil crisis and the initiation of the process of joining the EC. It was true that the Greek economy had been adversely affected by the worldwide recession, but the differences in the structure of the economies of Greece and other European countries had created sizable problems in the context of Greece's accession to the EC, and those problems would have to be dealt with in a cautious manner.

As Mr. Zhang had noted, Greece and other EC members faced a number of similar problems, including large fiscal deficits, substantial unemployment, and long-standing structural rigidities, Mr. Jayawardena remarked. In dealing with the economies of other European countries, the Fund had duly taken into account the deep-seated nature of those problems, and he wondered why a similar approach had not been taken in the formulation of the staff's recommendations to the Greek authorities.

He could go along with the staff's broad recommendations in its appraisal, although, as Mr. Coumbis had stressed, the precise pace of structural adjustment could be best determined only when the social and political realities of Greece were taken into account, Mr. Jayawardena commented. Moreover, the gradualist approach to adjustment did not involve needless postponement of the implementation of necessary adjustment measures. The authorities' present policy stance reflected to some extent the uncertainties arising from the long-standing structural problems and the effects of Greece's entry into the EC, but Mr. Coumbis's statement that the authorities intended to speed up the process of adjustment was encouraging.

The staff representative from the Exchange and Trade Relations Department remarked that the deceleration in the rate of inflation in 1984 had been due mainly to the slower rate of increase in administered prices than in market-related prices. However, the rate of increase in some market-related prices had also slowed in 1984 compared with 1983. Accordingly, the staff had concluded that the rate of inflation had declined in 1984, albeit modestly.

The staff did not have full information on the extent of official price controls and their influence on market-related prices, the staff representative went on. The authorities had indicated that they intended to liberalize prices, and the staff's description of the price-setting and monitoring mechanisms were meant to reflect the likely movement in that direction. The number of goods whose prices were set by the Ministry of Commerce had been reduced, and the procedures for monitoring prices had been changed, for instance, by shortening the period in which an entrepreneur or enterprise must wait before a price change proposed to the Ministry of Commerce could become effective. Moreover, the prices for some items of clothing, footwear, meat products, and fish products had been completely freed. While the authorities had stated their intention to liberalize prices, many market participants believed that the price control system was still widespread. That impression had been fostered by the authorities' efforts to rationalize accounting standards by encouraging enterprises, particularly smaller ones, to provide additional price and other information to the authorities.

As a rule, the staff felt that unit labor costs were an important indicator of the competitiveness of an economy, the staff representative remarked. In Greece, however, developments in export market shares over the previous seven or eight years corresponded more closely with developments in the consumer price index than with changes in the index for unit labor costs. The reasons for that were not obvious. Two possible causes might be the declining trend in profits and the rising trend in subsidies, which offset the effects of rising unit labor costs. In any event, it was clear that a substantial adjustment in the external sector--and particularly in merchandise trade--was required. Earnings from invisibles had declined, partly because tourism had fallen off somewhat and partly because of the falling demand for international shipping services. Greece's shipping sector was unlikely to recover its earnings position of previous years, and the authorities should increase the economy's reliance on exports of goods by restructuring the merchandise trade sector.

For that reason the staff attached particular importance to movements in the exchange rate, the staff representative went on. The staff had commended the authorities for the real depreciation of the exchange rate over the previous two years and had encouraged them to take further action in the exchange rate area, but those efforts would be fruitless in the absence of substantial changes in the wage indexation system; it would be pointless to attempt to improve competitiveness through an aggressive exchange rate policy alone.

The staff had concluded that a broad adjustment strategy was required; it was difficult to assign the highest priority to individual policy actions, the staff representative continued. The staff fully sympathized with the authorities, who had correctly noted that some of the economic problems were long-standing structural ones that were particularly difficult to solve, and who faced political constraints in taking appropriate policy actions. The authorities should take such actions across a broad policy front, wherever there was room to push forward. Certain complementary actions--for example, interrelated steps affecting exchange rate policy and the wage indexation system--were a prerequisite to successful adjustment. The authorities were concerned about the way in which the wage indexation scheme had been operating and had indicated that they planned to consider various possible changes, although they had not explained their intention in any detail. The wage indexation system had been adjusted occasionally over the previous several years. As a result, for example, the wage increases that would have been called for in 1983 under the indexation scheme had been delayed; and the nominal wage thresholds under the scheme had been adjusted in 1984. Moreover, there had been some restraint under the indexation system in 1985, when the nominal wage thresholds had not been adjusted for past inflation.

Several Directors had noted the authorities' reliance on revenue measures to reduce the fiscal deficit, the staff representative recalled. The authorities' medium-term program targets included keeping constant the share of expenditures in GNP. Accordingly, the authorities had planned a relatively small increase in expenditures and a shift in the composition of expenditure away from consumption and toward investment, although they might not be able to adhere fully to that objective in 1985. The medium-term program stressed the importance of broadening the tax base, and it was in that connection that the staff considered that there was room for a substantial increase in revenues. The agricultural sector was virtually exempt from taxation and provided scope for a substantial increase in revenues without adversely affecting investment incentives or production. In addition, the authorities were actively exploring ways to take advantage of the scope for improving the enforcement of existing tax legislation. However, although the authorities had explained that they had introduced new mechanisms and had made special arrangements to collect taxes and arrears, the projection in the 1985 budget for the reduction in those arrears seemed very optimistic. The authorities had also explained that the introduction of the value-added tax in 1986 was not intended primarily to increase revenues; the new tax rates had not yet been set, but they were to have a neutral or only a small positive effect on revenues.

The staff did not have sufficient data to distinguish between the shares of external borrowing for compensatory and investment purposes, the staff representative explained. The way in which the Greek monetary program was formulated left a residual of financing that was to be covered by foreign sources. The authorities arranged for such financing through the Bank of Greece, the Central Government, or public enterprises. The borrowing requirement was not determined solely on the basis of investment need. The authorities' objective was to have a variety of agents from Greece enter the international markets. In that connection, a public enterprise might well borrow abroad merely as a part of the authorities' effort to diversify Greece's entry into the international capital markets, and not because the enterprise wished to meet a particular need for foreign exchange to finance an investment project. In 1984, approximately one third of total foreign borrowing had been undertaken by the Bank of Greece and about two thirds by public enterprises; the Central Government had not entered the international capital markets in 1984.

Responding to Mr. Schneider's question about the consistency of certain pieces of data in the staff report, the staff representative said that the original national account statistics had been based on an estimate of trade for 1984 as a whole, rather than on customs-based balance of payments data through end-November. The revision of the customs-based data to cover all of 1984 would not be reflected precisely in the revision of the national accounts. In any event, the trade data for January-November 1984 had been interpreted with caution by both the authorities and the staff; the data had become available for the first time only on the last day of the staff mission in Greece and had shown unexpected developments, for example, in the volume of exports. The revised data for the full year 1984 had shown that the cautious approach for the data for the first 11 months of the year had been fully warranted. The staff had discussed the various statistical problems in Appendix III of SM/85/116. For example, the staff was concerned about the inconsistencies in the data that made it difficult to determine conclusively whether there had been an improvement or a deterioration in 1984 in something as basic as the foreign balance. In that connection, the balance of payments data on a settlements basis showed a clear deterioration, but the national accounts data did not. Such problems undermined the authorities' ability to monitor developments on a monthly basis.

All interest rates, except the rate on convertible drachma accounts, were set by the Bank of Greece, the staff representative explained. The staff had noted that, when various charges were included, lending rates were about 25 percent, clearly positive in real terms. Interest earnings on deposits were not taxable. Interest rates on drachma-denominated deposits were at best marginally positive in real terms. Interest rates on deposits denominated in foreign currencies were competitive by international standards. Since deposits denominated in foreign exchange had higher interest rates, they presumably were more attractive than drachma-denominated deposits. It was difficult to know how interest rates would behave if the market were free to set them. In that connection, it was interesting to note that interest rates of about 26 percent had emerged after the creation of the convertible drachma market in late 1984.

The rate of increase in reserve money had not been consistent with the behavior of inflation in Greece, the staff representative remarked. In explaining that development, it was useful to bear in mind that Greece's monetary system was not based on the control of reserve money through a stable money multiplier. In fact, the money multiplier in Greece was quite volatile, and monetary control was exercised partly through credit ceilings on the specialized credit institutions and partly through ceilings on reserve money in the commercial banking system. Reserve money had been excessive by any measure in 1984, but weak demand in the private sector had apparently kept money from expanding faster than it actually had. The staff felt that an increase in demand in the private sector in the coming period could well be a cause for concern. Accordingly, the behavior of reserve money would bear watching in the future.

Foreign exchange deposits in banks in Greece were not subject to a reserve requirement, the staff representative said. Commercial bank deposits in U.K. pounds and U.S. or Canadian dollars were typically redeposited with the Bank of Greece, which acted, in effect, as a broker for such deposits. Other currencies, particularly the deutsche mark, typically were sold by the commercial bank to the Bank of Greece; the sale usually included a repurchase agreement. The resulting drachma deposits were subject to a 7 percent reserve requirement.

The previous consultation with Greece had occurred in February 1984, the staff representative noted. The authorities had indicated that it would be more convenient for them to hold the next consultation in May 1986, rather than February 1986, and that, in any event, May was preferable in terms of the availability of data.

The establishment of the uniform salary scale had been of net benefit to some civil servants, the staff representative remarked. In introducing the new salary scale the authorities had endeavored to ensure that no civil servant would be worse off than under the old system. It could be argued that, while the introduction of a uniform salary scale at the time chosen by the authorities had been appropriate, it should perhaps have led to a lower increase in real wages in the government sector. However, the position of public sector salaries in relation to private sector salaries had not clearly suggested that the introduction of the uniform salary scale had been required. Of course, the introduction of the new scale at a time when wage restraint had been called for was not encouraging.

The impact on trade of Greece's entry into the EC was centered on agriculture, the staff representative commented. During the association period, prior to entry into the EC, there had been a substantial decline in import duties in Greece, and Greek exporters had had virtual duty-free access to the EC market. With the exception of the elimination of some quotas, Greece's membership in the EC had provided an incentive for trading in manufactures. The staff did not believe that Greece's manufacturing sector had suffered from so-called EC entry shock. Indeed, the share of manufactured items in total Greek trade in 1981-84 had changed only little; that conclusion applied to both imports and exports. However, agriculture and the balance of payments--through the terms of trade and the external current account--had experienced a substantial EC entry shock, although the effects had been at least offset by transfers from the EC.

The various taxes that had discriminated against imports into Greece when the country had entered the EC had been combined into a single regulatory tax in 1984 and that tax was to be phased out by 1989, the staff representative noted. Of the large number of export subsidies in Greece, some were to be phased out as part of Greece's entry into the EC, but the rest would be maintained. In addition, there were national agricultural subsidies that were not consistent with EC regulations. The authorities intended to phase out those subsidies but had not yet indicated a firm timetable for doing so. The phasing out of subsidies was yet another reason for adjusting the exchange rate.

The results of the program to assist problem enterprises were not yet clear, the staff representative commented. More than 100 enterprises had asked for assistance under the program, but only approximately one third of the requests had been accepted. At the time of the acceptance of those requests, the enterprises concerned had had some Dr 130 billion debt in arrears, primarily to a single bank. In that connection, it was useful to note that total reserves in the banking system were just Dr 70 billion. It might well be possible to make the enterprises concerned viable again, but a restructuring of their debt would clearly be required, and the sharing of the rescheduling burden had not yet been determined. Mention had been made of converting some of the debt to equity that would be held by the bank to which most of the overdue debt was due. Meanwhile, the moratorium on debt payments would continue to affect the banking system. In that connection, the authorities had agreed to pay the banks concerned 2 percentage points of the rates paid on so-called special time deposits in order to bolster the income position of those banks.

The question of the prospects for nondebt flows under current policies was a crucial one, the staff representative said. Such flows had covered some 80 percent of the external current account deficit in the 1970s; at present, the coverage was approximately 40 percent. Nondebt flows included real estate investments, entrepreneurial capital--including borrowing by foreign enterprises in Greece--and foreign exchange deposits. The latter were affected by interest rates that seemed to be competitive by international standards. Real estate investments and entrepreneurial capital were affected by the general investment atmosphere in Greece, which recent investment performance suggested was not positive. Thus, policy changes that would bolster the private sector's confidence could be expected to help the balance of payments as well as investment.

The authorities had made some progress under their gradualist approach to adjustment, for example, the simplification of the financial system, the staff representative noted. However, the needed reduction in domestic and external imbalances was not occurring. The reference by some speakers to a possible retrogression in adjustment under the gradualist approach was probably accurate. The cost of failing to achieve needed adjustment under the present gradualist approach constantly increased over time. The failure of private investment to rebound had led the Government to play a greater role in leading the recovery of the economy, but at the cost of a growing interest burden and an enormous fiscal imbalance. The staff had estimated that if the underlying fiscal deficit--other than interest payments--remained at the present level, interest payments by the Government would exceed 10-11 percent of GNP by the end of the 1980s.

Demand was not strong and apparently had not been a factor in the acceleration of inflation in Greece, the staff representative said. There seemed to be excess capacity in the economy, although the relevant statistics were not good. Moreover, private sector demand had been fairly weak in recent years. Given the existence of the wage indexation system, it was difficult to say whether the exchange rate depreciation had been a direct cause of the inflation in Greece, or vice versa. The inflationary effects of the oil price increases in the late 1970s and early 1980s had been reflected in the indexation mechanism, which, in turn, had suggested the need to depreciate the exchange rate in order to maintain competitiveness; the effects of the depreciation had subsequently been passed on to domestic prices. Hence, while the exchange rate had been partly responsible for the continuing inflation, it had not operated independently of the cost-push factors in the economy.

It was true that a particular subcategory of private investment--residential construction--had accounted for roughly half of the fall in total private sector investment, the staff representative remarked. It could also be argued that as residential construction had reached a relatively high level, the readjustment in that subsector was not surprising and was appropriate. The problem facing the economy was that the decline in other components of private sector investment had reflected the fall in productive investment in manufacturing at a time when an increase in such investment was needed to help solve structural problems. The inadequate adjustment of the 1970s could only be offset by a recovery in private sector productive investment in the coming period. Manufacturing investment had fallen by almost 20 percent in real terms in 1980-83, accounting for a large part of the total decline in private sector productive investment in that period.

Given the data problems described in the staff report, it was difficult to assess the pattern of income distribution in Greece, the staff representative commented. While the relevant national accounts income data were unavailable, the staff had examined data on nonagricultural wage income and entrepreneurial income, which suggested that there had been some upward movement in relative wage earnings in both the public and private sectors. The data on net profits were puzzling, as the definition in the Greek accounting system of net profit was unusual: gross profit minus depreciation, interest on certain categories of debt, and administrative costs, the last including white-collar labor. It was true that the increase in interest payments, owing to the rise in nominal interest rates, might help to explain the emerging difference between the relatively steady gross profit rate and the sharply declining net profit rate. However, it seemed arbitrary to decide that interest payments were the main cause of declining profits; wages had obviously played a role.

Mr. Coumbis remarked that his authorities, having fully recognized that the financial imbalances in the economy had increased, were prepared to take further action as necessary. However, there were some differences in emphasis between the staff and the authorities. The authorities believed that some adjustment in the fiscal and balance of payments areas had occurred in 1982 and 1983 and that even greater progress had been made in removing restraints on the implementation of credit policy. Positive developments had also occurred in 1984, and the deterioration in the external current account and the fiscal deficit in that year did not indicate that the authorities had reversed their general policy stance. Those negative developments had occurred mainly because of special exogenous or temporary factors. His authorities believed that structural problems as well as external factors helped to explain the domestic and external imbalances, the high rate of inflation, and the decline in private investment. The financial imbalances and declining private investment could not be reversed until the structural weaknesses had been tackled decisively.

External autonomous factors could easily knock a small and open economy off track, and the authorities in such countries must introduce a medium-term plan with firm and specific targets in order to correct structural problems and improve the financial imbalances in the medium term, Mr. Coumbis went on. Greece's five-year plan included a target of reducing the external current account deficit to 3.2-3.5 percent of GNP by 1987. Some of the staff scenarios suggested that Greece could regain a viable financial position if the target for the external current account deficit were reached. The authorities were committed to achieving that objective and had indicated that they intended to speed up the short-term stabilization effort in the wake of the increase in the domestic and external imbalances in 1984.

Given the domestic, social, and political constraints, Greece, like other countries, might have no choice but to maintain a gradualist approach to adjustment, Mr. Coumbis stated. The large financial imbalances in the United States and the continued high rate of unemployment in Western Europe were due partly to structural problems that could not be solved quickly because of social and political constraints.

There was some difference of opinion about the definition of gross and net profits, Mr. Coumbis remarked. The staff representative had mentioned that gross profits included personnel costs, but his authorities had noted that only the cost of high-level personnel had been included. Nevertheless, there was a problem in the sense that gross profits had been stable while net profits had been declining.

There was a long tradition--more than four decades--of price controls in Greece, Mr. Coumbis commented. Price controls had been intensified in 1973-82 through both direct administrative intervention and the price freeze in 1979. A gradual reduction of price controls had been initiated in 1982. The controls were being replaced by a system of surveillance based on improved accounting techniques that were being applied by the Government with the cooperation of the private sector.

He agreed with the staff that the wage indexation system greatly restricted the scope for maintaining a more active exchange rate policy, Mr. Coumbis said. However, it was important to bear in mind that the wage indexation system in Greece compensated on average for only about 70 percent of past inflation. When the system had been introduced, the Government had given clear signals to the public and the unions that it was determined to control inflation, and the wage indexation mechanism had played a decisive role in that effort.

The Acting Chairman made the following summing up:

> Executive Directors expressed serious concern about the developments in the Greek economy in 1984 and about the prospects for 1985 and beyond. Most Directors strongly supported the thrust of the analysis and policy recommendations expressed in the staff report and appraisal. In a number of respects--notably with regard to fiscal policy, the balance of payments, and the high level of domestic inflation--developments in 1984 were seen to have confirmed the concern expressed by Executive Directors at the previous consultation discussion that policies in place would be inadequate to meet even the modest targets which had been set for 1984.

Directors noted, in particular, the deterioration in the current account of the balance of payments, from a deficit of 5.4 percent of GNP in 1983 to 6.5 percent in 1984. This deterioration, which reflected previously continued weakness in the earnings of invisibles, was especially worrisome as it had occurred during a period of recovery among most of Greece's major trading partners--which in turn had helped to generate a fairly strong increase in merchandise exports--and despite the effects on imports of the declining levels of investment. These developments made it all the more urgent to implement policy measures which would be supportive of the authorities' goal of reducing the current account deficit to 3-3.5 percent of GNP by 1987 and which would avoid a further unsustainable rise in foreign debt. However, Directors saw little prospect for much improvement in 1985 on the basis of present policies, and supported the staff view that the external current account deficit was likely to be higher than now projected by the authorities.

Directors noted that the most recent data indicated that the overrun in the fiscal deficit had been even larger than originally estimated, as the net public sector borrowing requirement had increased substantially to 15 1/2 percent of GNP in 1984. This increase had undone the progress achieved in 1982 and 1983 in reducing the public sector borrowing requirement from its previous peak value of 14 1/4 percent of GNP in 1981. Directors thought that this overshooting of the deficit could not be wholly explained by the temporary factors stressed by the authorities but was symptomatic of more general problems underlying the management of the public sector.

These developments served to underscore the concerns expressed by the staff that policies envisaged for 1985 were likely to be insufficient to achieve the projected reduction in the public sector borrowing requirement to 12 3/4 percent of GNP. Directors emphasized that a sustained reduction in the public sector borrowing requirement over the medium term was essential and would require a coordinated approach in policies. For the Central Government, major efforts would be required to limit expenditure growth--including the government wage bill--and to reduce the pervasive system of subsidies supported by the budget. Implementation of measures to expand the tax base was another matter that should be given high priority. Directors welcomed the authorities' intention to introduce a value-added tax in January 1986; they also encouraged the authorities to review as quickly as possible the numerous tax exemptions granted to important sectors of the economy. Concerted policy measures to reduce the deficits of the public enterprises would also be required, including the adoption of appropriate pricing policies.

A number of Directors commended the authorities' continuing efforts to rationalize the banking and credit system. In this context, a welcome development in 1984 had been the increase in nominal and real interest rates on most bank deposits and on the Government's borrowing via treasury bills. Directors welcomed the authorities' intention to sell treasury bills directly to the nonbank public but cautioned that this should not be viewed as relieving the pressure to reduce the fiscal deficit. Directors noted that developments in 1984 offered further evidence that monetary policy in Greece was seriously pressured by the need to finance the public sector. Bank financing of the overrun of the public sector deficit in 1984 had led to an increase in monetary growth which was substantially above target and to a further shift in the composition of credit in favor of the public sector. Inflation continued to decelerate modestly. However, progress in reducing the still very rapid pace of inflation--especially, as some Directors noted, in comparison with the average rate of inflation in Greece's EC partners--would require a substantial tightening of monetary policy, supported by a significant reduction in public sector borrowing. Directors generally thought that the monetary target for 1985 was insufficiently ambitious on this account.

Directors noted with considerable concern the substantial increase in real wages in 1984 and the prospect of further significant increases in real wages in 1985, especially those resulting from the introduction of the uniform salary scale. These developments and prospects were clearly inappropriate in view of the needed shift in the use of resources from consumption to investment and exports. Many Directors stressed that major modifications leading to the abandonment of the system of wage indexation were urgently required before substantial progress could be expected in reducing inflation. In the absence of such a change, the pursuit of an active exchange rate policy--which in the view of Directors was clearly required as a complement to the necessary structural changes in industry emphasized by the authorities--would be severely compromised. In commenting on the continuing decline in private sector investment, some Directors noted the role played by the substantial decline of investment in dwellings and the impact of declining demand and structural problems in depressing investment in Greek industry. Directors nevertheless agreed with the staff assessment that the decline was closely linked with the steady fall in profit rates over the preceding decade, a development which government policy should firmly seek to reverse.

In sum, Directors considered developments in 1984 to have represented a reversal of the limited progress achieved in 1982 and 1983, notably with regard to the fiscal outturn, the balance of payments, and the continued decline in private investment. In the view of Directors, a policy of gradual adjustment was no longer a viable alternative. Rather, it was stressed that it was essential that measures be put in place urgently to secure a rapid and substantial reduction in both external and fiscal imbalances and that the deep-seated structural weaknesses in Greece's industry be tackled in a determined and coherent manner.

It is expected that the next Article IV consultation discussions in Greece will be conducted in May 1986 with a view to completing the consultation by August 1986.

The Executive Board then took the following decision:

1. The Fund takes this decision in concluding the 1985 Article XIV consultation with Greece, in the light of the 1985 Article IV consultation with Greece conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes that Greece continues, pursuant to Article XIV, to maintain restrictions on payments and transfers for current international transactions, as described in SM/85/122.

Decision No. 7977-(85/75), adopted
May 17, 1985

APPROVED: February 26, 1986

LEO VAN HOUTVEN
Secretary